January 2004

Rethinking Corporate Federalism in the Era of Corporate Reform

Renee M. Jones
Boston College Law School, renee.jones.2@bc.edu

Recommended Citation
Renee M. Jones. "Rethinking Corporate Federalism in the Era of Corporate Reform." *Journal of Corporation Law* 29, (2004): 625-663.

Rethinking Corporate Federalism in the Era of Corporate Reform

Renee M. Jones∗

ABSTRACT

Many commentators have criticized the Sarbanes-Oxley Act of 2002 as evidence of the "creeping federalization of corporate law."[1] In this Article, I argue that a realistic threat of federalization is necessary to ensure the robust development of corporate law at the state level. Recent research suggests that Delaware enjoys a monopoly position in the market for "out-of-state" incorporations. This means that little pressure actually comes from other states which might push Delaware to shape its corporate law to increase protections for shareholders and other constituent groups.

The federal government, however, can serve as a credible rival to Delaware. The Sarbanes-Oxley Act's apparent influence on Delaware corporate law suggests the potential for a dynamic relationship between state and federal regulation of corporate conduct. Recent Delaware court decisions indicate that Delaware's judiciary has begun to respond to this preemptive threat by adjusting its corporate law jurisprudence. The courts appear to be moving to more restrictive application of the business judgment rule and more vigorous enforcement of officers' and directors' fiduciary duties. This jurisprudential shift demonstrates that Congress can effectively influence state law through legislative measures that do not require complete preemption of state law.

∗Assistant Professor, Boston College Law School, J.D. Harvard Law School 1993, A.B. Princeton University 1986. This paper was presented to the Section on Securities Regulation at the Association of American Law Schools Annual Meeting in January 2004, and benefited from comments from fellow panelists and participants. Many thanks to my colleagues at Boston College Law School and to others who took time to comment on early drafts including Mary Bilder, George Brown, Victor Brudney, Chancellor William Chandler, Larry Cunningham, Robert Ellis, John Gordon, Kent Greenfield, Ingrid Hillinger, Michael Kang, Ray Madoff, Judy McMorrow, Jim Repetti, Fred Yen, and participants in faculty workshops at Boston College, Suffolk University, and University of Connecticut law schools. Thanks also to John Choe and Jinny Ahn for valuable research assistance. Research support for this Article was provided by a Boston College research grant generously funded by David Perini.

1. Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring, 2003, at 26.

I. INTRODUCTION

"If we don't fix it, Congress will, but I hope they've gone as far as they're going to have to go."[2] This statement from one of our country's most respected jurists forms part of an ongoing effort to retain the state of Delaware's legitimacy and power in the realm of corporate law, in the face of recent federal encroachments on state law territory. Delaware Supreme Court Chief Justice E. Norman Veasey made this statement in the wake of recent corporate scandals and Congress' subsequent adoption of the Sarbanes-Oxley Act of 2002[3] ("Sarbanes-Oxley" or the "Act").

Chief Justice Veasey's words are an unusually blunt acknowledgment that in determining the legal rules that affect America's largest corporations, the state of Delaware is constrained most significantly by the federal government. His words suggest that standard arguments prevalent in academic literature which extol the benefits of competition among states for corporate charters are misconceived. Instead, Chief Justice Veasey tacitly admits that the federal government is Delaware's main rival in the development of corporate law rules. This implied absence of state-to-state competition suggests the need to reconsider the appropriate role of the federal government as a corporate regulator.

To some, Sarbanes-Oxley represents an ill-advised advance in the "creeping federalization of corporate law."[4] The Act does indeed federalize some aspects of corporate law, and properly so. Because of Delaware's dominant position in the market for out-of-state incorporations, the federalization of corporate law (or at least the threat of federalization) is necessary to ensure that corporate law developed at the state level adequately addresses concerns of national scope, rather than furthering purely local interests.

The longstanding academic debate about whether competition among states for corporate charters has led to a "race-to-the-bottom" or a "race-to-the-top" in corporate law,[5] exaggerates the true extent of competition among states for corporate charters.

2. *What's Wrong with Executive Compensation?, A Roundtable Moderated by Charles Elson*, HARV. BUS. REV. Jan. 2003, at 68, 70 (quoting E. Norman Veasey, Chief Justice, Delaware Supreme Court) [hereinafter *Roundtable*].

3. Pub. L. No. 107-204 (2002), codified at scattered sections of 11, 15, 28 and 29 U.S.C.A. [hereinafter Sarbanes-Oxley or the Act].

4. *See* Bainbridge, *supra* note 1; *see also* Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN'S L. REV. 671, 672-74 (2002); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 57-59 (2002).

5. *See, e.g.*, Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); *see also* Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969) [hereinafter, *Law for Sale*]; RALPH NADER ET AL., TAMING THE GIANT CORPORATION (1976); Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947 (1990) (race-to-the-bottom); Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985) [hereinafter Romano,

Instead, recent scholarship suggests no race exists at all.[6] That is, when a corporation considers a state other than its home state in which to incorporate, it almost invariably chooses Delaware.[7] These same commentators have observed that other states do not actively compete with Delaware for charters.[8] Neither the statutes, the court systems, nor the corporate franchise tax structures of these states appear designed to allow the states to generate additional revenue by attracting out-of-state incorporations.[9]

For years, scholars have argued that competition among states leads to greater innovation and experimentation in the development of corporate law rules. The recent assertion that no meaningful interstate competition exists for out-of-state incorporations detracts from the market-based arguments these scholars invoke to refute the prescriptions of others who advocate national standards of corporate conduct. The dearth of competition also weakens these same scholars' arguments that the federal system of corporate law has led to the development of efficient or optimal corporate law rules.

For regulatory competition actually to impact the development of corporate law in a manner that properly balances management and shareholder interests, Delaware must have a rival. Only the federal government can offer an alternative regulatory scheme that can compete with Delaware for the public's acceptance. This Article's vision of regulatory competition departs sharply from the model of horizontal competition that dominates corporate law scholarship. In this view, regulatory competition is not driven by the pursuit of additional corporate charters or franchise fees. Instead, the rival regulators compete for the public's confidence and concomitant regulatory authority and power.

In this paradigm, voters play the primary role in achieving a desirable balance between federal and state power in corporate regulation. If the public disapproves of the actions of federal regulators in a substantive area, voters can elect representatives at the national level who will defer to states on such issues. In the context of corporate regulation, if Delaware, the dominant state for corporate law, regulates corporate affairs competently, then Delaware and other states should continue to enjoy broad regulatory authority. Conversely, if the public loses confidence in the existing regulatory regime, voters would be expected to pressure Congress to adopt laws that impose more appropriate standards. Such public pressure might lead Congress to preempt certain provisions of state corporate law. Such pressure may also lead states to take measures to forestall preemption by modifying state law to more closely comport with the demands of the voting public.

Delaware's response to the enactment of Sarbanes-Oxley suggests that Congress has the ability to prod Delaware to adopt corporate law rules preferred by voters, without resorting to wholesale replacement of state law with federal law. The Act has been

Law as Product]; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993) [hereinafter ROMANO, GENIUS] (race-to-the-top).

6. *See* Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002); *see also*, Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law*?, 90 CAL. L. REV. 1775 (2002).

7. Bebchuck & Hamdani, *supra* note 6, at 580-82.

8. *See id*.; Kahan & Kamar, *supra* note 6, at 701.

9. Kahan and Kamar, *supra* note 6.

described as "the most far-reaching reforms of American corporate practices since the time of Franklin Delano Roosevelt."[10] Unlike the reforms of the Roosevelt era, the Act departs from the securities laws' traditional model of disclosure regulation and mandates corporate governance reforms that previously had been the exclusive province of the states. Among other interventions, the Act forbids all corporate loans to directors and executive officers and dictates the composition and responsibilities of the audit committee of the board of directors.[11] With these provisions, the Act displaces some of the basic tenets of state corporate law.

The realistic threat of federal preemption posed by Sarbanes-Oxley seems to have influenced Delaware's judiciary. In recent decisions, its judges have taken a firmer stance against directors when evaluating shareholders' fiduciary duty claims. It is likely that Sarbanes-Oxley and other corporate reform proposals of national scope prompted or contributed to this shift in Delaware jurisprudence. Delaware's judicially-led reforms suggest that limited preemption of state law can play an important role in the development of corporate law at the state level. This dynamic, if fostered, can afford the national citizenry a voice in shaping the corporate law rules devised by a non-representative body of policy-makers, which, in turn, could lead to a more democratic and more principled regulatory scheme.

In this Article, I argue that the recently renewed federal engagement in corporate law issues should be welcomed and sustained. However, in contrast to other proposals, I do not advocate wholesale federal preemption or the development of an optional federal regulatory scheme.[12] Instead, I urge a sustained vigilance from Congress and a willingness to take limited preemptive measures when state corporate law rules fall short in providing adequate protection for investors.

Part II reviews the longstanding debate on the corporate law race and, like other recent commentators, concludes that no race exists at all. Part III reviews current thinking about corporate federalism. Part IV proposes an alternative model of vertical regulatory competition, and argues that it represents a better paradigm for analyzing regulatory competition in the corporate law arena. Part V describes the political factors that led Congress to adopt Sarbanes-Oxley. Part VI explains how the Delaware courts have led the state's response to Sarbanes-Oxley's preemptive threat. It analyzes recent developments in Delaware law and argues to the federal preemptive threat prompted them.

II. THE "RACE" DEBATE

A. The Modern Debate

For almost thirty years, academics have debated about whether competition among states for corporate charters has precipitated a race to the top or a race to the bottom in

10. Elisabeth Bulmiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1 (quoting President George W. Bush).

11. *See* the Act, §§ 301, 402 and *infra* text at notes 99-106.

12. *See, e.g.*, NADER ET AL., *supra* note 5, at 63-71; Lucian Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 143-44 (2001) (advocating an "opt-in" federal takeover law with choice controlled by shareholders).

corporate law. The debate is central to corporate legal scholarship, for at its essence it is a debate about the proper substance of corporate law rules. In our federal system of corporate law, state governments set the rules governing the relationships among the primary participants in the corporate enterprise: directors, officers and investors. Each state has its own corporate statute and a corporation may incorporate under the laws of any state, regardless of whether it owns assets or conducts operations in that state. Under the "internal affairs doctrine," it is the law of the selected state that governs all disputes regarding a corporation's internal affairs, regardless of the forum in which such disputes are litigated.[13] Although the federal securities laws and other federal laws impose significant limitations on corporate operations, the U.S. has no federal corporate statute.[14]

Because corporations pay franchise taxes and other fees to the states in which they incorporate, many commentators have argued that states compete for corporate charters and the tax revenues they generate.[15] That more than half of all publicly-traded corporations incorporate in Delaware leads most to conclude that Delaware has "won" this competition.[16] The "race" debate thus centers on determining why Delaware has won the race for corporate charters and, more importantly, whether the legal rules generated as a result of this race are the appropriate ones.

Race-to-the-bottom theorists argue that regulatory competition has had a negative impact on the development of corporate law.[17] William Cary most forcefully articulated this view. Cary argued that Delaware, in its zeal to maintain its primacy as the favored state of incorporation, adopted legal rules that favor managers at the expense of shareholders.[18] He asserted that because corporate managers enjoy exclusive power to select or change the state of incorporation, Delaware had declared it to be the "public policy of the State" to adopt legal rules that managers desired.[19] Implicit in Cary's argument is the premise that government regulation is necessary to prevent corporate managers from exploiting shareholders who exercise little meaningful control over the modern corporate enterprise. Having concluded that the federal system discourages such active regulation, Cary urged Congressional legislation as the only means to effect the regulatory regime he viewed as essential to maintain the proper balance of power among managers, shareholders and other corporate constituents.[20] He thus proposed the establishment of federal minimum standards of corporate conduct that would apply to

13. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971); *see also* McDermott Inc. v. Lewis, 531 A.2d 206, 218-19 (Del. 1987) (declining to apply Delaware law to a dispute involving a Panamanian corporation).

14. Despite Congress's constitutional authority under the commerce clause to regulate corporations engaged in interstate commerce, under the internal affairs doctrine a delineation has been established by which Congress regulates only what is understood to be external corporate affairs, such as securities trading, labor relations and consumer protection, and leaves internal governance matters exclusively to the states. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 596-98 (2003) (discussing the contours of the internal affairs doctrine).

15. *See, e.g.*, Cary, *supra* note 5, at 665-66; Winter, *supra* note 5, at 253.

16. *See, e.g.*, BAUMAN ET AL., CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 61 (5th ed. 2003) (concluding that Delaware has "won" the corporate law race); JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 36-38 (2d ed. 2003) (discussing reasons for Delaware's primacy).

17. *See, e.g.*, Cary, *supra* note 5, at 666, 670.

18. *Id.* at 670-71.

19. *Id.* at 663 (quoting Law of December 31, 1963, ch. 218 [1963] 54 Del. Laws 724).

20. *Id.* at 700-03.

large American corporations.[21]

Defenders of the corporate federal system (referred to here as corporate federalists) argue that the very interstate competition that Cary so excoriated, has led instead to a "race-to-the-top" in corporate law.[22] These theorists, led by Ralph Winter, agree with Cary that the federal system discourages active regulation of corporations, but they embrace this deregulatory bias as the legitimate result of the corporate law race.[23] Race-to-the-top theorists maintain that market forces are sufficient to prevent excessive managerial self-dealing and opportunism.[24] They take the market-based defense of the federal system a step further by arguing that not only do conventional market forces rein in management excess, but that a competitive market for corporate law works to ensure that states will adopt legal rules that appeal to managers and shareholders alike.[25]

Thus, Winter argued, if Delaware law permitted managers to profit at the expense of shareholders, earnings of Delaware corporations would lag behind those of similar corporations chartered in other states.[26] This would result in lower stock prices for Delaware corporations, increasing their capital costs and weakening their position in the product market, ultimately driving stock prices still lower and making such corporations attractive takeover targets.[27] Race-to-the-top theorists thus conclude that market forces require corporate managers to seek out legal rules that are attractive to investors, which in turn encourages states to adopt legal rules that "optimize the shareholder-corporation relationship."[28] Thus, in the view of race-to-the-top scholars, Delaware's laissez faire approach to corporate governance is superior to the interventionist model preferred by race-to-the-bottom theorists, simply because this laissez faire approach has "won" a vigorous competition among all states to attract the most corporate charters.[29]

B. The Reality

Despite the longevity of the race debate, recent empirical studies demonstrate the fallacy of the fundamental assumption upon which the great debate rests—that states actively compete for corporate charters. In separate studies, Lucian Bebchuk and Assaf Hamdani, and Marcel Kahan and Ehud Kamar have asserted that the interstate competition which has been credited with fueling the corporate law race is largely illusory.[30] These commentators show that not only is Delaware the clear leader in chartering publicly-traded corporations, but that no other state serves as a credible rival to Delaware in attracting charters from out-of-state corporations.[31]

21. *Id.* at 701.

22. *See, e.g.*, Winter, *supra* note 5, at 275-76; EASTERBROOK & FISCHEL, *supra* note 5, at 212-15; ROMANO, GENIUS, *supra* note 5, at 16-24.

23. *See, e.g.*, Winter, *supra* note 5, at 275.

24. *See id.* at 262-66; *see also* EASTERBROOK & FISCHEL, *supra* note 5, at 4 (arguing that market forces drive managers "to act as if they had investors' interests at heart"); ROMANO, GENIUS, *supra* note 5, at 86-88.

25. Winter, *supra* note 5, at 253; ROMANO, GENIUS, *supra* note 5, at 15-32.

26. Winter, *supra* note 5, at 256.

27. *Id*.

28. *Id*.

29. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 5, at 6, 214-15; Romano, *Law as Product*, *supra* note 5, at 280-81.

30. *See* Bebchuk & Hamdani, *supra* note 6, at 579-82; Kahan & Kamar, *supra* note 6, at 724-35.

31. Kahan & Kamar, *supra* note 6, at 724-35.

It is common knowledge that Delaware is the state of incorporation for more than half of all publicly-traded companies.[32] Yet, the true extent of Delaware's dominance in the market for corporate charters becomes apparent only when the field is defined as the market for "out-of-state" incorporations. With the market so defined Delaware's market share increases to 85%.[33] In addition, several factors protect Delaware from being displaced from its dominant position by other states. Much of the value that Delaware's legal system offers corporations stems from the large number of other firms that choose to incorporate there. For example, Delaware's extensive body of corporate law decisions developed only because of the volume and diversity of cases presented to its courts.[34] In addition, Delaware's institutional infrastructure, including its specialized court system, expert judiciary, and specialized bar would be difficult for other states to readily duplicate. These advantages work together to protect Delaware's dominant position.[35] As a result, Delaware has no meaningful competition in the market for out-of-state incorporations.[36]

In addition to Bebchuk's and Hamdani's insights, Professors Kahan and Kamar argue that contrary to the central assumption in the corporate race debate, other states are not making serious efforts to compete with Delaware for corporate charters.[37] Kahan and Kamar analyzed the corporate franchise tax and fee structures of all states, and concluded that states other than Delaware stand to gain little economically from attracting additional incorporations.[38] For example, Nevada, the so-called "Delaware of the West," earns marginal annual revenues of only $26,200 from the eighteen companies that went public as Nevada corporations between 1996 and 2000.[39]

By persuasively demonstrating the absence of interstate competition in the development of corporate law, these recent studies detract from the standard arguments of corporate federalists who advance and defend the free-market approach to corporate law embodied in the states' enabling corporate law codes.[40] Because there is no meaningful interstate competition for corporate charters, competition could not have affected the development of corporate law in the way that corporate federalists posit. Thus, corporate federalists' defense of the states' enabling corporate codes must rest on other grounds.

The absence of vigorous competition among states for corporate charters does not by itself establish that fundamental problems exist in the corporate law rules that states created. It is one thing to refute the assertion that interstate competition exists, and has led to optimal corporate law rules, and quite another to demonstrate that the existing rules

32. Delaware is home to 57.75% of all publicly-traded corporations and 59% of the Fortune 500 corporations, excluding financial firms. Bebchuk & Hamdani, *supra* note 6, at 568.

33. *Id*. at 556, 578.

34. *Id.* at 586; *see also* Romano, *Law as Product, supra* note 5, at 280; ROMANO, GENIUS, *supra* note 5, at 44.

35. *See generally* Michael Klausner, *Corporations, Corporate Law and Networks of Contracts*, 81 VA. L. REV. 757 (1995) (discussing network externalities).

36. Bebchuk & Hamdani, *supra* note 6, at 593-96.

37. Kahan & Kamar, *supra*, note 6, at 724.

38. *Id.* at 684-85.

39. *Id.* at 693.

40. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 5, at 214-15; ROMANO, GENIUS, *supra* note 5, at 85-117.

are flawed. Nonetheless, there are valid reasons to suspect that certain problems will persist in corporate law when the rules are established through a political process that managerial interests dominate. Such problems are likely to arise with respect to three broad categories of issues: (1) management's ability to retain its powers and privileges (i.e., election of directors and takeover defenses); (2) managerial self-dealing (i.e., executive compensation, conflicts of interest, unfair dealing with minority interests); and (3) interests of stakeholders and society (i.e., rights of creditors, employees and externalities).[41]

Simply put, when legal rules require a balancing of competing interests, a lack of input in the regulatory process from all concerned interests makes it unlikely that an optimal balance will be achieved. An extensive body of literature explores the legal problems that arise in the areas identified above.[42] Part VI of this Article examines corporate law doctrine in Delaware and highlights many of the problems implicated here.

III. Horizontal vs. Vertical Regulatory Competition

A. Horizontal Competition

Traditional corporate law theory has focused almost exclusively on the purported benefits of horizontal regulatory competition while ignoring another important federalist ideal: that state governments would compete with the federal government for regulatory power. A core argument of corporate federalists is that the federal (state-based) system enhances the development of corporate law through reliance on competitive mechanisms that federal intervention would hamper. These theorists argue that the fifty states and the District of Columbia function as regulatory laboratories that facilitate innovation in the development of rules that improve the substance of corporate law.[43] When competing states observe successful experiments in innovative states, they adopt similar rules which leads to the optimal corporate legal rules prevailing throughout the nation.[44]

Corporate federalists also argue that national regulation as advanced by Cary and others would disrupt this ideal competitive process because the federal government would enjoy monopoly power, nullifying the ability of competitive forces to advance optimal legal rules.[45] Finally, opponents of national-level regulation argue that such regulation would not likely do better than state law in protecting shareholders as Congress is just as susceptible to business lobbying as state legislatures.[46]

Some scholars have challenged the corporate federalists' unvarnished view of the superiority of state-level regulation in corporate law. William Bratton and Joseph McCahery assert that the economic theory that underlies the corporate federalist model

41. Professor Bebchuk has explained why these are the most likely problem areas for corporate law in the current federal system. *See* Bebchuk, *supra* note 5, at 1441, 1458-94.

42. *See, e.g.*, Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 624-40 (1997); Victor Brudney & Robert C. Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 998, 1022-42 (1981).

43. *See* Romano, *Law as Product*, *supra* note 5, at 280-81; ROMANO, GENIUS, *supra* note 5, at 5.

44. ROMANO, GENIUS, *supra* note 5, at 5.

45. *See* Romano, *Law as Product*, *supra* note 5, at 281.

46. *See id*. at 230.

has been significantly qualified by economists.[47] They point out that Charles Tiebout's model of horizontal regulatory competition sought only to demonstrate the superiority of local level determination of government expenditures on public goods and services, such as police protection, public schools, and swimming pools.[48] Legal scholars subsequently integrated Tiebout's model into legal literature as they sought to expand the model to apply to the "production" of government regulation.[49] The Tiebout model thus became a basis for the defense of current system state-based corporate regulation.[50] However, most public economists now concur that the Tiebout model is burdened by too many unrealistic assumptions to predict reliably the superiority of local level regulation over national regulation.[51] Therefore, public economists have either rejected or significantly modified the Tiebout model to account for its weaknesses.[52] Based on this newer economic learning, Bratton and McCahery conclude that the superiority of local level regulation cannot be assumed based solely on theories of horizontal competition.[53]

Despite the Tiebout model's lack of robustness, legal theories derived from this outmoded model continue to thrive among legal academics.[54] For example, recent critiques of Sarbanes-Oxley cite the purported benefits of horizontal competition in their assault on the evolution of "federalized" corporate governance standards.[55] Unfortunately, because of their exclusive focus on illusory state-to-state competition and their disregard for the importance of vertical competition, these corporate federalists fail to acknowledge the potential benefits of competition from the federal sector.

B. Vertical Competition

Despite its curious absence from the debate on corporate law competition, the concept of vertical competition was central to the framers' vision of the federalist system.[56] The dual regulatory authority of federal and local governments was part of the

47. *See* William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 205 (1997) [hereinafter, Bratton & McCahery, *Devolutionary Federalism*].

48. *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956).

49. Bratton & McCahery, *Devolutionary Federalism, supra* note 47 at 205-06.

50. *Id.* at 209.

51. *Id.* at 222-25.

52. *See id.* at 243-44.

53. Bratton & McCahery, *Devolutionary Federalism*, *supra* note 47, at 260-61.

54. *See id.* at 219-22.

55. Stephen Bainbridge asserts that:

> [c]ompetitive federalism promotes liberty as well as shareholder wealth. When firms may freely select among multiple competing regulators, oppressive regulation becomes impractical. If one regulator overreaches, firms will exit its jurisdiction and move to one that is more laissez faire. In contrast, when there is but a single regulator, exit is no longer an option and an essential check on excessive regulation is lost.

Bainbridge, *supra* note 1, at 31. Larry Ribstein similarly argues that "[f]ederalizing corporate governance should be approached with caution. The state-based system of regulating corporate governance can be considered one of the main strengths of the U.S. capital markets." Ribstein, *supra* note 4, at 58.

56. *See* Todd E. Pettys, *Competing for the People's Affection: Federalism's Forgotten Marketplace*, 56 VAND. L. REV. 329, 338-45 (2003) (discussing the Federalist papers); *see also* George D. Brown, *New Federalism's Unanswered Question: Who Should Prosecute State and Local Officials for Political Corruption?*, 60 WASH. & LEE L. REV. 417, 434-35 (2003) (discussing federalism concepts).

framers' design. They anticipated that such a system would enable the public to "giv[e] most of their confidence where they may discover it to be most due."[57] Thus, the original federalists envisioned that state and federal governments would compete to persuade the public as to which was better suited to regulate in a particular field.[58] The public would observe which level of government exercised regulatory authority in a field and could evaluate that regulator's performance. If dissatisfied with the dominant regulator's performance, voters could lobby for intervention from an alternative regulator and thereby shift regulatory authority from the states to the federal government or vice versa.

In contrast to modern federalists' unyielding attacks on federal regulation, the original federalists were more circumspect about the proper limits of federal power. In James Madison's view, any expansion of federal power in response to voters' demands would bear legitimacy. He argued that:

> [i]f . . . the people should in [the] future become more partial to the federal than to the State governments, the change can only result from such manifest and irresistible proofs of a better administration, as will overcome all their antecedent propensities.[59]

In the modern context, the model of vertical regulatory competition predicts that if states regulate corporations competently, federal deference to state authorities would be politically popular and national politicians who eschewed extensive federal regulation would be elected to federal office. Conversely, if states failed to regulate adequately or permitted a regulatory void, the federal government could step in and win public confidence by filling the existing void with regulation that voters demand. In such a context, federal regulation would become politically expedient and politicians who supported such regulation could expect to be re-elected.[60]

In a contemporaneous work, Mark Roe also argues that the federal government is Delaware's main competitor in the corporate law realm.[61] Roe argues that the federal government reserves for itself those areas of corporate law that it wishes to regulate, leaving the states to regulate the remainder of the field.[62] Whenever the federal government disapproves of state policy, it may, and often does, preempt state law.[63] Roe also observes that the federal government can influence Delaware law through many mechanisms that fall short of preemption.[64]

Roe's arguments are consonant with this Article's description of federal corporate reform legislation provoking reform at the state level. However, Roe refrains from offering a normative evaluation of the proper role of national regulation in the development of corporate law. In contrast to Roe's agnosticism, this Article asserts that

57. Pettys, *supra* note 56, at 341 (quoting THE FEDERALIST NO. 46 (James Madison)).

58. *Id*. at 333.

59. THE FEDERALIST NO. 46 (James Madison), *in* 2 THE FEDERALIST: A COLLECTION OF ESSAYS, WRITTEN IN FAVOUR OF THE NEW CONSTITUTION, AS AGREED UPON BY THE FEDERAL CONVENTION, SEPTEMBER 17, 1787 84, 85-86 (2001).

60. *See* Pettys, *supra* note 56, at 345-53 (reviewing the history of the American public's favor and disfavor for federal regulation).

61. Roe, *supra* note 14, at 591-93.

62. *Id*. at 596-98.

63. *Id*.

64. *Id.* at 601-07.

adherence to basic democratic principles justifies federal intervention, particularly when such intervention represents a legislative response to public demands for significant legal reform.

IV. TOWARD A NEW MODEL OF VERTICAL REGULATORY COMPETITION

Recent scholarship demonstrates a lack of interstate competition for corporate charters, exposing a gap in modern theories of regulatory competition in corporate law. This Article's proposed model of vertical competition attempts to fill that gap. Vertical regulatory competition is not driven by a regulator's desire to maximize revenues, but by the quest for popular legitimacy and its attendant authority to regulate.[65] The rival regulators (the state and federal governments) compete with one another for the confidence of voters who will reward, with their votes, those politicians whom they perceive as protecting their interests, and penalize those who do not. This model of regulatory competition better explains recent developments in corporate law, in which the Delaware judiciary is apparently seeking to regain public confidence by reforming its law as part of a bid to prevent further federal preemption.

A. Advantages

The vertical model has normative appeal because it recognizes the need for policymakers to consider a broader range of interests than the horizontal competition model deems important. As Cary and others have observed, a policymaking process characterized by horizontal competition encourages policy makers to appeal to management interests, to the exclusion of the interests of all other corporate constituents, because management initiates the selection of the state of incorporation and retains control over any reincorporation decision.[66]

The race-to-the-top paradigm advanced by Winter and others relegates investors to a reactive role and accepts their exclusion from participation in the policy debate when legal rules are crafted. In Winter's paradigm, the only role for shareholders in the regulatory process is that of ratifying or rejecting management's choice by choosing whether or not to invest in a corporation chartered in a particular state. Under this model, investors face a "take it or leave it" proposition. Because of the convergence of modern corporate law rules, the law of all states is essentially the same and investors are deprived of any meaningful choice.

In contrast, the presence of vertical competition pushes policy-makers at both the state and federal level to give greater consideration to the interests of investors and broader societal issues. Nationally dispersed shareholders lack direct political influence in Delaware, while management interests are well-represented.[67] At the national level, in

65. *See* Pettys, *supra* note 57, at 332-33.

66. *See* Cary, supra note 5.

67. Many scholars have documented how Delaware's corporate bar controls the process of amending the state's corporate code. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV 469, 506-09 (1987) (describing the reasons for the Delaware bar's dominance of the regulatory process); ROMANO, GENIUS, supra note 5, at 28-31 (discussing Macey's and Miller's analysis); *Law for Sale*, *supra* note 5, at 868 (describing the role of the drafting committee of the 1967 Delaware Corporation Law Revision Commission); Ernest Folk, III, *Some Reflections of a Corporation Law*

contrast, representatives of shareholder interests, can participate directly in policy debates.[68] Sophisticated and organized aggregations of shareholders can and do lobby Congress and the SEC to ensure that shareholder interests are considered. Labor unions, public pension funds, and trade groups such as the Council for Institutional Investors have the wherewithal to make a persuasive case to Congress and the SEC.[69]

As a policy matter, encouraging vertical competition is preferable to promoting horizontal competition among states. Federal engagement provides voters throughout the country an opportunity to persuade Congress to preempt those state law provisions that lack popular support. This dynamic allows investors to influence state corporate law, if only indirectly. A posture of absolute federal deference to state regulators would deprive citizens of this power, enhancing management's dominance of the state regulatory process.

B. Objections

1. The Federal Constraint is too Weak

Several commentators have acknowledged the preemptive threat's disciplining effect on Delaware. Yet, they generally conclude that the federal constraint is too weak and sporadic to be relied upon to affect state law significantly.[70] For example, Bebchuk and Hamdani argue that the federal constraint is "hardly a tight one" and that it requires the federal government to identify corporate governance arrangements that harm

Draftsman, 42 CONN. BAR J. 409, 410-12 (describing the composition of the Delaware Corporate Law Committee).

68. The roster of witnesses at the Senate hearings on Sarbanes-Oxley demonstrates the breadth of perspectives available to national policy makers. The witnesses included Paul Volcker (former federal reserve chairman), Charles Bowsher (former comptroller general), Richard Breeden (former SEC chairman), Arthur Levitt (former SEC chairman), John Biggs (chairman of TIAA-CREF), Sarah Teslik (executive director of the Council of Institutional Investors), and Professors Joel Seligman and John Coffee. Report of the Senate Committee on Banking, Housing and Urban Affairs to accompany S. 2673 July 3, 2002, S. REP. No. 107-205 (2002), *reprinted in* HAROLD S. BLOOMENTHAL, SARBANES OXLEY ACT IN PERSPECTIVE (2003 ed.).

69. These groups lobby the SEC from time to time to adopt new rules to enhance shareholder rights. For example, in response to prodding from institutional investors and labor unions, the SEC adopted a rule requiring mutual funds to disclose their proxy votes to investors. *See* Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Investment Companies, Securities Act Release 33-8188, *available at* www.sec.gov/rules/final/33-8188.htm (last visited Apr. 7, 2004); 17 CFR Pts. 239, 249, 270, 274. The SEC also recently proposed a new "shareholder access" rule which would, in certain circumstances, allow significant shareholders to include their own nominees for the board of directors in the management proxy statement. *See* Proposed Rule: Security Holder Director Nominations, Exchange Act Release No. 34-48626 (Oct. 14, 2003), *available at* www.sec.gov/rules/proposed/34-48626.htm (last visited Apr. 7, 2004). The SEC has received thousands of comment letters on the shareholder access proposal from groups as disparate as the Business Roundtable, state bar associations, labor unions, and public pension fund managers. These comment letters are available at http://www.sec.gov/rules/proposed/s71903.shtml (last visited on Apr. 7, 2004). A similar debate occurred on the merits of the mutual fund disclosure rules. Comment letters on this proposal are available at www.sec.gov/rules/proposed/s73602.shtml (last visited Apr. 7, 2004).

70. *See* Bebchuk & Hamdani, *supra* note 6, at 604-05; *but see* Roe, *supra* note 14, at 596-98 (departing from general skepticism about the federal government's ability to effect change in state law without resorting to preemption).

shareholders and seek to correct them.[71] Bratton and McCahery similarly argue that political barriers make it difficult for shareholder groups to influence national policy, and that Delaware, when threatened, easily defuses the federal threat through minimal concessions to shareholders.[72]

The vertical competition model emphasizes Congress's ability, through incremental action, to impact law significantly at the state level. Indeed, recent developments in Delaware corporate law show that commentators may have underestimated the latent power of the preemptive threat and misgauged the limited precision with which Congress must act to evoke a significant state-level response. By engaging in quite limited preemption, the Act, along with other national reform proposals, has significantly influenced the development of state law. Congress did not need to precisely identify all of the flaws in state corporate law and systematically address them. To effect state-level reform, Congress merely needed to demonstrate that it was willing to exercise its constitutional authority to preempt state corporate law. Even though as a matter the exercise of federal preemptive power in the corporate realm has been episodic, it need not remain so. By continuing to scrutinize and evaluate corporate affairs, the federal government can maintain its disciplinary role.

To sustain vertical competition, federal regulators must remain willing to intervene when the public becomes dissatisfied with the state regulatory regime. Prior to Sarbanes-Oxley, the federal government eschewed dictating corporate governance standards and instead sought to regulate corporate conduct through an awkward amalgamation of tax policy and securities law disclosure requirements.[73] The corporate scandals sparked public outrage which forced the federal government into a mode of direct regulation. This development disrupted the stagnant environment in which modern corporate rules had evolved.

2. Delaware's Dominance Lacks Legitimacy

A stronger critique of the advocacy for constrained and limited federal preemption rests on the argument that scant justification exists for allowing a small state such as Delaware to dictate the law on issues having a significant impact on the national economy.[74] Thus, a complete shift of regulatory authority from the states to the federal government is preferable to the limited preemption advanced here. Although there is some appeal to this argument, several factors caution against replacing state law with a federal incorporation scheme.

Because of the states' historical role in the development of corporate law, considerable expertise and experience in grappling with corporate law issues is vested in

71. Bebchuk & Hamdani, *supra* note 6, at 604-05.

72. *See* William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1900-03 (1995).

73. For example, in 1992, the SEC overhauled regulations on executive compensation disclosure in an effort to better inform shareholders on the issue. *See* Executive Compensation Disclosure, 17 C.F.R. Pts. 228, 229, 240, and 249 (2002). Congress also vainly attempted to rein in perceived excesses in executive compensation through amendments to the tax code. *See* I.R.C. §§ 162(m), 280G (1991).

74. *Cf.* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1105 (1997) (discussing Delaware's precarious position as a small state providing national legal rules).

state authorities. State-based law and jurisprudence have considerable value to businesses and lawyers representing sunk costs that may be squandered if federal law entirely replaced state law. Furthermore, there are some advantages to local-level regulation even in the absence of horizontal regulatory competition. Local chartering offers advantages in terms of cost and convenience that a federal regime could not match. States may be more responsive to citizen concerns than the federal government, and opportunities for experimentation afforded by the state-centered system should be preserved where possible. Although this attribute has been oversold by corporate federalists, some useful corporate reforms are made possible because of the ability of multiple jurisdictions to experiment with changes in the law.[75]

More importantly, the state regulatory regime can continue to serve as a regulatory "safety valve." If federal regulation fails due to corruption or regulatory capture, the state-centered system provides an alternative venue for addressing future problems. The importance of this safety valve can be shown by analogy to the securities enforcement regime. When New York Attorney General Eliot Spitzer brought enforcement actions against the major Wall Street investment banks and brokerage houses, he exposed rampant analyst fraud on Wall Street and ultimately prodded the SEC into action.[76] His investigation led to a $1.4 billion settlement among the banks, the SEC, New York, and other states.[77] Less than one year later, Spitzer again exposed systemic fraud in the mutual fund industry.[78] Spitzer's actions and those of other state regulators have revitalized competition between state and federal regulators in securities enforcement.[79] Similarly, state regulation of corporations can back-stop federal regulation, if in the future voters become dissatisfied with federal enforcement of corporate governance standards.

C. Summary

In summary, allowing states to continue to regulate corporations appears to offer some benefits over a purely federalized scheme. Yet, for the reasons discussed above, states should not enjoy exclusive authority in this realm. Because Congress can influence state corporate law without preempting it entirely, a practical resolution for corporate reform seems to be closer Congressional scrutiny of corporate regulation, aided by limited preemption when necessary to correct for states' propensity to place the interests of managers above other corporate constituents in crafting corporate law.

75. One example is the creation of the limited liability company, a new entity created by states to provide the benefits of partnership tax treatment and corporate limited liability within a single entity.

76. *See* Gretchen Morgenson & Patrick McGeehan, *Wall Street Firms are Ready to Pay $1 Billion in Fines*, N.Y. TIMES, Dec. 20, 2002, at A1.

77. *See Finding Fraud on Wall Street*, N.Y. TIMES, Apr. 29, 2003, at A28.

78. *See* Landon Thomas, Jr., *SEC Putting Mutual Funds Under Scrutiny on Late Trading*, N.Y. TIMES, Sept. 5, 2003, at C1.

79. *See* Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 519-24 (2003) (discussing the resurgence of state securities regulators).

V. SARBANES-OXLEY: THE FEDERAL PREEMPTIVE THREAT

Examining the Sarbanes-Oxley Act's impact on the development of state corporate law offers an opportunity to evaluate whether the threat of federal preemption actually works the way the vertical model of regulatory competition would predict. This Section demonstrates how public dissatisfaction with state-based corporate regulation prodded Congress to adopt Sarbanes-Oxley which preempts certain provisions of state law. The following Section examines Delaware's response to Sarbanes-Oxley.

A. Corporate Scandals

The widespread corporate governance scandals revealed in late 2001 through 2002 followed on the heels of the technology bubble bust and exacerbated a prolonged bear stock market. The political pressure resulting from the scandals led Congress to enact Sarbanes-Oxley. The corporate scandals involving Enron, WorldCom, and others emerged amidst a legal environment of judicial deference to corporate directors and officers.[80] The prevailing legal regime provided little deterrence, and few effective means for shareholders to redress corporate wrongdoing.[81] The wisdom of the states' laissez-faire approach to corporate governance became more dubious with each unfolding scandal.

The scandals evoked broad public dissatisfaction with the existing corporate regulatory regime.[82] As a result, Congress and other federal regulators were compelled to address the perceived problems.[83] This popular pressure for more extensive corporate regulation was significant, as it empowered Congress to encroach significantly on traditional state law terrain for the first time since the Great Depression.

After Enron's bankruptcy in December 2001, political pressure for federal corporate law reform began to mount. Congress held a series of widely-publicized hearings featuring disgraced executives such as Enron's Jeffrey Skilling and Kenneth Lay, along with newly minted heroes like Sherron Watkins.[84] Soon thereafter, the Justice Department indicted Arthur Andersen for obstruction of justice for trying to cover up its role in Enron's accounting irregularities.[85] Federal lawmakers filed bills proposing

80. *See infra* Part VI.C.

81. *Id*.

82. A poll conducted in June 2002, revealed that 57% of Americans distrusted corporate executives. The same proportion of Americans believed that corporate scandals were a major problem for the nation. John Harwood, *Americans Distrust Institutions in Poll*, WALL ST. J., June 13, 2002, at A4. Despite his overall high approval ratings (67%), Americans disapproved of President Bush's handling of corporate and financial market problems by a margin of 46% to 40%. *Business Ties Now Bind Nation's CEO—Many Americans Give the First M.B.A. President Poor Marks for Handling Corporate Scandals*, WALL ST. J., July 24, 2002, at A4.

83. The appeal for federal reform represents an implicit rejection of state governments as the proper fora for corporate reform legislation, despite the states' historical dominance in this area. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 876 (2003) (observing that "almost no one is talking about state regulation or law to combat the corporate governance problems").

84. *See* Greg Hitt, *Senators Vent Frustration at Silence of Enron's Lay*, WALL ST. J., Feb. 13, 2002, at A3; Tom Hamburger, *Enron's Watkins Describes 'Arrogant' Culture*, WALL ST. J., Feb. 15, 2002, at A3; Greg Hitt & Tom Hamburger, *Skilling Denies He Misled Enron Officials*, WALL ST. J., Feb. 27, 2002, at A3.

85. Andersen was indicted on March 14, 2002. *See* John R. Wilke, *Top Prosecutor in Andersen, Enron*

myriad corporate reforms, as erstwhile SEC chairman Harvey Pitt embarked on a reform effort aimed at restoring investor confidence.[86] The New York Stock Exchange and Nasdaq also put forth significant corporate governance reform proposals with a national scope.[87]

Despite the flurry of Congressional activity, a federal corporate reform bill was far from a certainty.[88] President Bush attempted to forestall such efforts with his own more limited reform proposals.[89] Indeed, the Congressional proposals stalled until a second wave of scandals hit the presses in the early summer of 2002.[90] The balance finally tipped in favor of sweeping corporate reform legislation when WorldCom revealed that it had overstated its profits by $3.8 billion.[91] With mid-term Congressional elections looming, national politicians felt pressure to "do something" about corporate fraud. Fewer than three weeks after WorldCom's announcement the corporate reform bill passed in both the House and the Senate.[92] After an accelerated conference process, both houses of Congress approved the Sarbanes-Oxley Act of 2002, which President Bush quickly signed into law on July 31, 2002.[93]

B. Sarbanes-Oxley

Sarbanes-Oxley represents an amalgamation of corporate reform proposals that had drifted through the halls of Congress since the Enron debacle first came to light.[94] The Act reformed regulation of the accounting industry,[95] enhanced securities law disclosure

Cases Plays for Keeps, WALL ST. J., Mar. 15, 2002, at A12.

86. *See* Harvey L. Pitt, Remarks at the 29th Annual Securities Regulation Institute, Jan. 23, 2002, *available at* http://www.sec.gov/news/speech/spch536.htm (last visited Mar. 3, 2004); Harvey L. Pitt, *How to Prevent Future Enrons*, WALL ST. J., Dec. 11, 2001, at A18.

87. *See* Report of the NYSE Corporate Accountability and Listing Standards Committee (June 6, 2002), *available at* http://www.nyse.com/pdfs/corp-govreport.pdf (last visited Mar. 3, 2004); Proposed Amendments to Nasdaq Rules, Oct. 9, 2002, SR-NASD-2002-141, *available at* http://www.nasdaq.com/about/SR-NASD-141_NASDAQ_Rule_filing.pdf (last visited Apr. 7, 2004).

88. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 U. CONN. L. REV. 915, 924-25 (2003) (describing the confluence of events that led Congress to enact Sarbanes-Oxley).

89. *See* Press Release, White House, President Announces Tough New Enforcement Initiatives for Reform (July 9, 2002), *available at* http://www.whitehouse.gov/news/releases/2002/07/20020709-4.html (last visited Mar. 3, 2004); Jennifer Grossman, *Commentary; It's About Time for a Little Payback; Errant Execs Owe Us . . . and There's a Way to Collect*, L.A. TIMES, July 22, 2002, at B11.

90. These included scandals at Tyco, Adelphia, ImClone and WorldCom.

91. Jared Sandberg et al., *WorldCom Admits $3.8 Billon Error in Its Accounting*, WALL ST. J., June 26, 2002, at A1. The extent of the fraud was later increased to $9 billion. *See* Deborah Solomon & Jared Sandberg, *WorldCom's False Profits Climb*, WALL ST. J., Nov. 6, 2002, at A3.

92. *See* Jonathan D. Glater & David Leonhardt, *Corporate Conduct: The Impact; Both Sides Say Bill Addressing Business Fraud Is a First Step*, N.Y. TIMES, July 25, 2002, at C1 (stating that "[t]he two houses of Congress rushed to pass competing versions of the bill in recent weeks, saying they wanted to prevent repeats of the spectacular corporate scandals at Enron, WorldCom, and others"); Richard A. Oppel Jr., *Negotiators Agree on Broad Changes in Business Laws*, N.Y. TIMES, July 25, 2002, at A1 ("The legislation has enjoyed extraordinary momentum in the last three weeks. But its outlook had been cloudy until mid-June," when scandals at Tyco, Adelphia, and WorldCom made it risky for any politician to object to the measure.).

93. Bulmiller, *supra* note 10, at A1.

94. *See* Cunningham, *supra* note 88, at 918-19.

95. The Sarbanes-Oxley Act, §§ 101–08.

requirements,[96] created a number of new white-collar crimes,[97] and enhanced criminal and civil penalties for corporate fraud.[98] In a marked departure from the securities laws' traditional mode of disclosure regulation, the Act directly regulates corporate governance. In reaction to reports of abuse at Enron, WorldCom, Adelphia, and others, the Act bans all corporate loans to officers and directors.[99] In contrast to Congress' bright line rule, most states permit such loans, subject only to vague standards embodied in the duty of loyalty.[100]

The Act also encroaches on state law by specifying requirements for the composition and conduct of the audit committee of the board of directors. The Act requires each public corporation to have an audit committee comprised solely of "independent" directors.[101] The Act's definition of independence is more stringent than that embodied in Delaware common law. To qualify as independent under the Act, a director cannot accept payment of any consulting, advisory, or other compensatory fees other than director fees.[102]

In addition, the Act reallocates many key responsibilities from corporate management to the audit committee.[103] It specifies that the audit committee must retain responsibility for appointing, compensating, and overseeing the work of the company's independent auditor, and that the auditors must report directly to the committee.[104] The Act also demands that the audit committee have the authority to hire independent advisers, such as lawyers and accountants, and that companies must provide the committee with the necessary funding to fulfill its newly-designated duties.[105] Finally, the Act requires the audit committee to establish a reporting system for the receipt of confidential, anonymous reports from employees concerning questionable accounting or auditing matters.[106] In contrast to the Act's requirements, Delaware law affords the full board the authority to designate committees, with discretion to determine committee composition and to delegate (or withhold) authority to committees as it wishes.[107]

C. Critiques of Sarbanes-Oxley

A first wave of academic commentary has criticized the Act generally for the haste with which it was adopted,[108] and more specifically for what some say is the ill-advised

96. *Id*. §§ 302, 401–09.
97. *Id*. §§ 802, 906, 1102-07.
98. *Id.* §§ 305, 804, 1105.
99. *Id.* § 402.
100. *See, e.g.*, DEL. CODE ANN. tit. 8, § 143 (2002).
101. The Sarbanes-Oxley Act, § 301.
102. *Id*. Compare to case law discussed *infra* Part VI.C (discussing Delaware standards for director independence pre-Enron). The New York Stock Exchange, the American Stock Exchange, and the Nasdaq stock market have also adopted more stringent standards for director independence further pressuring Delaware to conform its common law to the emerging national standards. *See, e.g.*, Final NYSE Corporate Governance Rules, *available at* http://www.nyse.com/pdfs/finalcorpgovrules.pdf (last visited Mar. 3, 2004).
103. The Sarbanes-Oxley Act, § 301.
104. *Id.*
105. *Id.*
106. *Id.*
107. *See* DEL. CODE ANN. tit. 8, § 141(c) (1974).
108. *See, e.g.*, Cunningham, *supra* note 88, at 917-23 (describing reforms as "modest"); Perino, *supra* note

step across the well-respected lines established by the internal affairs doctrine.[109] These substantive critiques, however valid, gloss over an important point.[110] The Act's very adoption triggered an important reaction and initiated legal reforms with impact beyond its limited substantive provisions. When analyzed as part of the complex dynamic of vertical competition, the Act is properly viewed as a critical political response to public dissatisfaction with the states' performance as virtually exclusive regulators of internal corporate affairs.

VI. DELAWARE'S RESPONSE

A. The Perceived Threat

As the model of vertical regulatory competition would predict, the public outrage over the corporate scandals appears to have affected the Delaware judiciary, which is ever mindful of Congress' preemptive power. In response, Delaware's judiciary has taken the initiative to reform its state's corporate law in an effort to forestall further federal preemption. This reform effort has been facilitated by the state's open-ended, standards-based jurisprudence which allows judges to adjust the law in response to external forces without having to explicitly acknowledge such efforts.

Powerful parties in Delaware could suffer significantly in the event of broad federal preemption of state corporate law. Most obviously, uniform federal standards could erode Delaware's relative appeal to corporate managers, resulting in the significant loss of franchise tax revenues.[111] In addition, members of the Delaware bar and judiciary would personally feel the impact of federal preemption.[112] Delaware lawyers rely heavily on revenues generated from serving as local Delaware counsel to corporations located throughout the country.[113] These corporations consult Delaware practitioners due to their exclusive access to the Delaware courts and their expertise in Delaware corporate law. If federal corporate law were to supplant Delaware law, much of this expertise could be rendered moot. Adopting uniform federal standards would make corporate practitioners throughout the country prospective experts in the new federal corporate law, and could reduce or eliminate the need to regularly consult Delaware counsel.

In addition, the Delaware judiciary's power and prestige might wane if new federal statutes required corporations to litigate significant shareholder disputes in federal court anywhere in the country. Delaware state courts would not exercise jurisdiction over as many high-profile disputes and the judiciary's prominence would diminish. With so

4; John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990's*, 89 CORNELL L. REV. 269, 302-07 (2004) (criticizing the Act for failing to address the fundamental causes of the scandals).

109. *See* Bainbridge, *supra* note 1, at 26; Ribstein, *supra* note 4, at 57-59.

110. A comprehensive analysis of the substance of the Act is beyond the scope of this Article. Instead, this Article focuses on the Act's potential impact on state corporate law.

111. Bebchuk and Hamdani estimate that 27% of Delaware's annual tax revenues come from franchise tax revenues. Bebchuk & Hamdani, *supra* note 6, at 581 n.66.

112. *See* Kahan & Kamar, *supra* note 6, at 694-99 (discussing benefits to the Delaware bar from litigation centered in Delaware); s*ee also* Romano, *Law as Product*, *supra* note 5, at 278-79; *Law for Sale*, *supra* note 5, at 888-90.

113. *See* Kahan & Kamar, *supra* note 6, at 694-99.

much at stake for so many players, it is not surprising that Delaware's decision-makers are anxious about the federal preemptive threat.[114]

B. The Judicial Response

The Delaware judiciary is well-situated to respond to the preemptive threat, perhaps better situated than the legislature or other state courts.[115] The open-ended nature of Delaware jurisprudence has allowed its courts to respond swiftly and deftly to forestall federal action.[116] Certain Delaware judges have acknowledged their perceived role as first-responders to the threat of federal preemption. These judges have publicly expressed concern with possible problems in state corporate jurisprudence revealed by Enron and other scandals, despite the fact that the largest frauds occurred at corporations chartered elsewhere. These same judges have suggested that unless states act quickly to address these weaknesses, the federal government may preempt their authority.[117]

Writing in early 2002, Delaware Vice-Chancellor Leo Strine predicted that "the Enron debate will create pressure on the current standards of state corporation law, and . . . participants in the policymaking process will identify what they perceive as inadequacies in that law, which they will cite as justifying a stronger role for federal regulation."[118] Acknowledging the importance of the federal-state competitive dynamic, he predicted that state policymakers "can be expected to be responsive to legitimate concerns."[119] He noted that such policymakers include state judges, like himself, "who play the leading role in formulating and enforcing the fiduciary duties of corporate directors and officers."[120]

Norman Veasey, Chief Justice of the Delaware Supreme Court, has revealed similar concerns about the federal preemptive threat. He has urged corporate directors to act more vigilantly in setting executive compensation, "not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to

114. *See generally* Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public Choice Explanation of Federalism*, 76 VA. L. REV. 265 (1990) (discussing various interest groups in Delaware and their dependence on the "capital asset" of the Delaware corporate law regime). Corporation service companies which facilitate the formation and legal maintenance of Delaware corporations by out-of-state corporations are another influential group in the development of Delaware law. For a discussion of the corporation service companies' role in shaping Delaware's 1967 statutory revisions, see *Law for Sale*, *supra* note 5, at 865.

115. Delaware's legislature recently adopted a number of statutory amendments which expand the chancery court's jurisdiction to assist plaintiffs seeking to bring actions against officers of Delaware corporations. These statutory revisions were recommended by the Delaware Bar Association in response to Enron and other recent events. *See* 18 CORP. COUNS. WKLY. 185, 185-86 (June 18, 2003).

116. *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1925-28 (1998) (arguing that indeterminacy helps explain Delaware's superior position in the corporate charter market); Rock, *supra* note 74, at 1016 (describing Delaware court decisions as "judgmental factual recitations . . .[that] sometimes impose legal sanctions, but surprisingly often do not").

117. *See, e.g.*, *Roundtable*, *supra* note 2, at 77 (quoting Chief Justice Veasey); Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on Corporate Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1372 (2002) ("Congress may even be tempted to consider federalizing key elements of corporate law . . .").

118. Strine, *supra* note 117, at 1372.

119. *Id.*

120. *Id.* at 1372-73.

them in court from a properly presented complaint."[121] Acknowledging the Delaware courts' role in forestalling the preemptive threat, the chief justice bluntly stated: "[i]f we don't fix it, Congress will, but I hope they've gone as far as they're going to have to go."[122]

Reflecting the tenor behind judicial pronouncements about the risk of federal preemption, recent Delaware decisions suggest a trend toward stricter judicial scrutiny of director decision-making. Since June of 2002, the Delaware Supreme Court has reversed chancery court decisions in favor of defendant directors, and ruled for the shareholder-plaintiffs six times.[123] This series of reversals represents a sharp departure from earlier patterns, in both the number of reversals and the number of pro-shareholder decisions.[124] Moreover, the supreme court's jurisprudential shift has trickled down to the court of chancery, which apparently has taken heed of the supreme court's message after such an unusual string of reversals.[125]

Ironically, the indeterminacy of Delaware law makes it impossible to demonstrate conclusively that the law has changed, or to identify the causes of any purported shift. The Delaware courts are famous for announcing new standards of conduct, while claiming that such standards have always existed.[126] In spite of the hazards of

121. *Roundtable*, *supra* note 2, at 76.

122. *Id*. at 77.

123. *See* Krasner v. Moffett, 826 A.2d 277 (Del. 2003); Omnicare, Inc. v. NCS Healthcare Inc., 818 A.2d 914 (Del. 2003); MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003); Saito v. McKesson HBOC, Inc., 806 A.2d 113 (Del. 2002); Levco Alternative Fund Ltd. v. Readers Digest Ass'n, Inc., 803 A.2d 428 (Del. 2002); Telxon Corp. v. Meyerson, 802 A.2d 257 (Del. 2002).

124. By comparison, in 2000 the Delaware Supreme Court reviewed 4 court of chancery decisions and reversed 2 of them. In 2001, it reviewed 9 court of chancery decisions and reversed only 2. A search in the Westlaw "DE-CS" database for Delaware Supreme Court cases on corporate fiduciary duties revealed the following decisions: Parnes v. Bally Entertainment Corp. 788 A.2d 123 (Del. 2001) (affirming judgment for directors in action challenging the fairness of a merger); Gentile v. Singlepoint Fin., Inc., 788 A. 2d 111 (Del. 2001) (affirming rejection of director's claim for advancement of legal fees under indemnification by-law); Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2001) (reversing judgment for defendants based on exculpation defense because trial court had neglected to first conduct an entire fairness analysis); MCA, Inc. v. Matsushita Elec. Indus. Co., Ltd., 785 A.2d 625 (Del. 2001) (affirming denial of objecting plaintiffs' motion to vacate a class action settlement); White v. Panic, 783 A.2d 543 (Del. 2001) (affirming dismissal of derivative action against directors for improperly handling allegations of CEO's sexual harassment of employees); Malpiede v. Townson, 780 A.2d 1075 (Del. 2001) (affirming dismissal of duty of care claims based on exculpation defense); Account v. Hilton Hotels Corp., 780 A.2d 245 (Del. 2001) (affirming dismissal of shareholder action challenging validity of corporation's poison pill); Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. 2001) (affirming dismissal of action challenging the fairness of a short-form merger); Rossdeutscher v. Viacom, Inc. 768 A.2d 8 (Del. 2001) (reversing the dismissal of contract claim in connection with rights issued in a merger but affirming dismissal of unjust enrichment claim); Int'l Telecharge, Inc. v. Bomarko, Inc., 766 A.2d 437 (Del. 2000) (affirming judgment for plaintiffs in duty of loyalty claim and affirming the denial of plaintiff's claim for disgorgement of post-merger profits); McMullin v. Beran, 765 A.2d 910 (Del. 2000) (reversing dismissal of minority shareholder's claim challenging parent company's sale of its subsidiary); Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170 (affirming dismissal of claim for inadequate disclosure in a cashout merger); Brehm v. Eisner 746 A.2d 244 (Del. 2000) (affirming dismissal for failure to make demand but reversing the "with prejudice" aspect of the dismissal).

125. *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003); *In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003). These cases are discussed *infra* at Part VI.D.

126. *See* Rock, *supra* note 74, at 1072-88 (rejecting doctrinal explanations of Delaware takeover law); Kamar, *supra* note 116, at 1914-18; Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty*

speculating about what motivates judges in their decisionmaking,[127] the following analysis seeks to analyze Delaware's recent decisions in their political context.

C. Delaware Law: Pre-Enron

The Enron scandal prompted broad scrutiny of corporate law and launched Congressional hearings on corporate reform. Therefore, the scandal serves as a convenient dividing line for an analysis of recent trends in judicial decisionmaking. This section reviews the state of Delaware law before Enron and identifies the legal doctrines that made it difficult for shareholders to enforce the fiduciary duties of officers, directors, and controlling shareholders that are at the heart of corporate law.

Before Enron, Delaware was the state where managers turned for assurances of minimal exposure to personal liability for mistakes, misjudgments, wrongdoing, or self-dealing. As one corporate treatise states, "businesses that quest certainty of results, as well as a sympathetic and experienced ear to the problems of running a public corporation, are assured of finding it in Delaware."[128] A combination of legislative provisions, judge-made rules, and procedural mechanisms worked together to provide officers and directors a virtually impregnable shield from monetary liability for corporate misdeeds.

Under standard notions of corporate governance embodied in state law, a corporation's board of directors and its executive officers manage the affairs of the corporation.[129] Shareholders' governance rights are strictly limited to a nominal right to elect directors and the right to veto certain fundamental transactions. The limited governance role afforded shareholders has led to what many consider to be the central problem in modern corporate law: managing the tension caused by the separation of ownership from control in the large publicly-held corporation.[130] The separation of ownership from control is said to create the classic agency problem. Managers are tempted by opportunities to shirk and steal.[131] To deter management malfeasance and to provide shareholders a remedy for managerial shirking or stealing, the law imposes on managers, as agents of the corporation, the fiduciary duties of loyalty and care. Until recently such shareholder protections were more theoretical than real.

1. The Duty of Care

Although Delaware has no statutory formulation of a director's fiduciary duties, its courts have developed a standard of conduct against which to measure a director's

---

Law After QVC *and* Technicolor*: A Unified Standard (and the End of* Revlon *Duties?)*, 49 BUS. LAW. 1593, 1609-14 (1994) (discussing doctrinal inconsistencies in Delaware takeover law).

127. Cunningham & Yablon, *supra* note 126, at 1626 (stating that "[p]redicting the course of Delaware law from prior case law is like watching clouds. They seem, at times, to take on recognizable shapes and forms, even to resemble something familiar. But you know that whatever shapes you think you see can vanish in a puff of wind.").

128. COX & HAZEN, *supra* note 16, at 39.

129. DEL. CODE ANN. tit. 8, § 141 (2002).

130. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 114-15 (1968); *see also* BAUMAN ET AL., *supra* note 16, at 456.

131. *See* ROBERT C. CLARK, CORPORATE LAW 33-34 (1986).

actions.[132] *Guth v. Loft, Inc*. set forth an early formulation of a director's fiduciary duty, as demanding of a director the duty "not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it."[133] So stated, the duty of care appears to impose a significant burden on corporate managers. In reality, however, the state legislature and courts have fashioned a number of mechanisms that, until recently, eliminated any real threat of monetary liability for a breach of the duty of care.

The business judgment rule significantly qualifies the general proposition that directors have a duty of care to the corporation. It imposes a rebuttable presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[134] In most instances, the invocation of the business judgment rule suffices to insulate directors from liability to the corporation or its shareholders for losses that result from poor decision-making.[135] Despite the broad protection the business judgment rule provides, it will not shield every director action from judicial scrutiny. Exceptions to the business judgment rule apply to decisions tainted by fraud, illegality, or conflict of interest.

The most amorphous and unpredictable exception to the business judgment rule is for failure to take proper care in decision-making: the procedural duty of care.[136] The famous *Smith v. Van Gorkom*[137] decision invoked this standard, and concluded that the board of directors of TransUnion Corporation had failed to "act with informed reasonable deliberation" before approving the sale of the company.[138] Although *Van Gorkom* raises the specter of potentially limitless personal liability for directors, the decision was an aberration in Delaware jurisprudence and has been almost uniformly criticized.[139] No subsequent Delaware decision has premised director liability on a breach of the duty of care.[140]

Corporate management's displeasure with *Van Gorkom* led Delaware's legislature to adopt Section 102(b)(7), a provision that permits corporations to "exculpate," or eliminate, directors' monetary liability for the breach of the duty of care.[141] Section

132. *Id*. at 123.

133. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

134. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

135. *See, e.g.*, Williams v. Geier, 671 A.2d 1368 (1996); Kahn v. Sullivan, 594 A.2d 48 (Del. 1991); *In re* Caremark Int'l Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

136. *See* COX & HAZEN, *supra* note 16, at 191-95 (discussing *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)).

137. 488 A.2d 858 (Del. 1985).

138. *Id.* In *Van Gorkom*, the court opined that TransUnion's board had failed to fulfill its duty of care because the board spent less than two hours considering the merger proposal, and approved the agreement without reading it, relying instead on a 20-minute oral presentation by the CEO who had secretly negotiated the merger. *Id*.

139. *See, e.g.*, Lawrence Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477, 485-91 (2000) (criticizing *Van Gorkom*); *see generally* Symposium, Van Gorkom *and the Corporate Board: Problem, Solution or Placebo*, 96 NW. U. L. REV. 449 (2002).

140. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATIONS AND FINANCE 150, n.45 (8th ed. 2002).

141. DEL. CODE ANN. tit. 8, § 102(b)(7). *See also* KLEIN & COFFEE, *supra* note 140, at 143.

102(b)(7) does not permit exculpation for breaches of duty of loyalty, acts or omissions not in good faith, or knowing violations of law.[142] Despite these exceptions, the reality remains that if a corporation has adopted an exculpatory charter provision, its directors enjoy reasonable assurance that they will not incur personal liability for ordinary breaches of the duty of care.[143] The scarcity of Delaware decisions holding directors liable for the breach of the duty of care,[144] coupled with the right to exculpation, has led most commentators to conclude that the fiduciary duty of care, if not ephemeral, exists only as an aspirational and unenforceable standard.[145]

2. Duty of Loyalty

The business judgment rule does not protect board decisions that are alleged to result from an officer's, director's, or controlling shareholder's self-interest.[146] Ostensibly, the duty of loyalty holds such parties liable for unfairly enriching themselves at the corporation's expense. As with the duty of care, the common law prohibition on managerial self-dealing has eroded over the years.[147] Formerly, the dominant common law rule was that an action by a shareholder could void a corporate transaction with an interested director.[148] This rule gave way to the modern "fairness" test, under which an interested transaction is not void if it is fair to the corporation.[149] Delaware's legislature further modified this common law rule when it adopted section 144, which provides that a transaction between a corporation and one of its officers or directors is not void or voidable solely because of the conflict, if the transaction is approved by a majority of the disinterested directors, a committee of disinterested directors, or by the shareholders, or if the transaction is fair to the corporation at the time of its approval.[150]

Disinterested director approval of a conflict of interest transaction has served as a reliable method for protecting potentially opportunistic corporate transactions from judicial scrutiny. Although the law is muddled, many cases have held that approval of a transaction by disinterested directors or shareholders results in application of the business judgment rule.[151] Thus, directors often succeed in precluding judicial review of conflict of interest transactions by appointing a committee of independent directors to negotiate

142. DEL. CODE ANN. tit. 8, § 102(b)(7).

143. *See, e.g.*, Malpiede v. Townson, 780 A.2d 1075, 1093-95 (Del. 2001) (upholding the dismissal of a duty of care claim or the grounds that a § 102(b)(7) provision precluded monetary recovery).

144. *See* Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099-2000 (1968) (comparing the search for cases finding liability for breaches of duty of care to a search for a needle in a haystack).

145. *See, e.g.*, CLARK, *supra* note 131, at 124-26; KLEIN & COFFEE, *supra* note 140, at 151-54.

146. CLARK, *supra* note 131, at 124.

147. *Id*. at 166-75.

148. *See* Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36 (1966).

149. *Id.* at 39-40. *But see* Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655, 662 (1992) (disputing Marsh's analysis).

150. DEL. CODE ANN. tit. 8, § 144. Other state corporate codes have similar provisions. *See* MODEL BUS. CORP. ACT, ch. 8, subch. F, §§ 8.60-8.63 (1969).

151. *See, e.g.*, Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976); Marciano v. Nakash, 535 A.2d 400, n.3 (Del. 1987); *In re* Wheelabrator Tech. S'holders Litig., 663 A.2d 1194, 1203 (Del. Ch. 1995).

and approve the terms of such transactions or by obtaining disinterested shareholder approval.[152] Although Delaware courts have been more rigid in reviewing conflict of interest transactions between a corporation and its controlling shareholders, its courts have frequently accorded such transactions business judgment rule protection.[153] But, in the controlling shareholder context, courts sometimes hold that disinterested director approval merely shifts the burden to the plaintiffs to show that the transaction is unfair.[154] This burden-shifting rule has been applied consistently only in the context of cash-out mergers, when minority shareholders are forced to cash in their shares at a price dictated by controlling shareholder or its designated directors.[155]

Weinberger v. UOP, Inc.[156] announced the modern rule by which cash-out mergers are evaluated under an "entire fairness" standard.[157] Although the *Weinberger* court found the controlling shareholder liable, it stated as dicta that the appointment of an independent committee to negotiate merger terms at arms-length was a "strong indication" that the resulting transaction satisfied the entire fairness standard.[158]

Outside of the cash-out merger context, the legal effect of disinterested director approval of controlling shareholder transactions remained unresolved. Courts sometimes review such conflicts under the business judgment rule and at other times apply the fairness test.[159] The uncertainty regarding the appropriate application of these competing standards of review allows courts significant discretion in evaluating board conduct in any particular case.

3. Procedural Protections

Delaware courts have reinforced the substantive limitations on director liability with procedural barriers to plaintiffs' claims against directors. In particular, the demand

152. Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).

153. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (applying business judgment rule to plaintiff's challenge to subsidiary's dividend to its parent); Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971) (applying business judgment rule to corporation's real estate purchase from controlling shareholders).

154. *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (articulating the entire fairness standard); *see generally* Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110 (Del. 1994) (applying burden shifting rule); Emerald Partners v. Berlin, 726 A.2d 1215, 1222-23 (Del. 1998) (approval by disinterested directors shifts burden to plaintiffs); *see also* Cooke v. Oolie, 26 DEL. J. CORP. L. 609, 625 (Del. Ch. 2000) (noting that plaintiffs must show actual conflict of interest to rebut the presumption that the business judgment rule applies); Rabkin v. Olin Corp., 16 DEL. J. CORP. L. 851, 861-62 (1990) (describing the terms under which the burden of proof shifts with a special committee).

155. *See generally Weinberger*, 457 A.2d at 711; *Kahn*, 638 A.2d at 1117. The emergence of fairness as the unyielding standard of review in cash-out merger cases has a convoluted history. In *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), the Delaware Supreme Court imposed a business purpose requirement for all cash-out mergers. *Id.* at 980. Seven years later, in *Weinberger*, the supreme court overturned *Singer*, abandoning the business purpose requirement for the current fairness rule.

156. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

157. *Id.* at 711.

158. *Id.* at 701 n.7. *Kahn*, 638 A.2d at 1116-17, reiterated the burden-shifting effect of disinterested committee approval of a cash-out merger transaction. In *Kahn*, the court held that the burden did not shift to plaintiffs because of evidence that the independent committee that negotiated the merger lacked independence and real bargaining power. *Id.*

159. *See* Williams v. Geier, 671 A.2d 1368 (Del. 1996) (affirming summary judgment for defendants in challenge to a recapitalization plan approved by an independent committee and shareholders).

requirement and the special litigation committee device frequently functioned to allow directors to dismiss derivative litigation on procedural grounds and thus avoid litigating the substantive merits of the shareholders' claims.[160]

a. Demand Requirement

Under the demand requirement, a shareholder may not bring a derivative action without first making a demand on the corporation's directors to bring the suit directly, unless the plaintiff can show that such a demand would be futile.[161] The demand requirement as initially interpreted by Delaware courts did not present a significant challenge to plaintiffs.[162] This interpretation changed with the supreme court's decision in *Aronson v. Lewis*.[163] In *Aronson*, the court announced a two-part test, under which the court of chancery must determine whether "under the particularized facts alleged, a reasonable doubt is created that the directors are disinterested and independent [or] that the challenged transaction was otherwise the product of a valid exercise of business judgment."[164] If the complaint satisfies either condition, demand is excused and the case may proceed.

b. Special Litigation Committees

Despite the demand requirement's protective power, instances occurred when courts excused demand based on futility.[165] In this situation, a corporation's directors would have an additional opportunity to avoid litigating the shareholders' case on the merits by appointing a special committee of independent directors to review the litigation. Under this mechanism, interested directors (who had been adjudged disabled from objectively considering a demand) hand-picked the members of a special committee charged with evaluating the merits of the litigation and the corporation's interest in continuing it.[166] The special litigation committee would then engage in an extensive investigation and produce a report that almost invariably concluded that continuing the litigation was against the corporation's interests.[167] The report of the special litigation committee then

160. COX & HAZEN, *supra* note 16, at 429 (asserting that "[t]he demand requirement . . . is the single most challenging hurdle that lies in the path of the derivative suit plaintiff").

161. Del. Ch. Ct. R. P. 23.1.

162. COX & HAZEN, *supra* note 16, at 427-28. Before *Aronson*, plaintiffs satisfied the demand futility standard by simply naming a majority of directors as defendants in the litigation.

163. 473 A.2d 805 (Del. 1984).

164. *Id*. at 814. The facts of *Aronson* show how this test erects a significant barrier. In *Aronson*, the plaintiffs challenged an employment agreement and loans to Fink, a former director and 47% stockholder. *Id.* at 808. The plaintiffs had alleged that Fink dominated the board because he had personally selected the directors and through his voting power controlled the election process. *Id.* The court held these allegations insufficient to establish an inference of Fink's domination and control. On remand, however, the court of chancery determined that demand excusal was appropriate under the newly announced standard. Lewis v. Aronson, 11 DEL. J. CORP. L. 243 (1985).

165. For example, when all of the directors are implicated in the litigation or benefited from the alleged conflict of interest transaction. *See, e.g*., Rales v. Blasband, 634 A.2d 927 (Del. 1993).

166. *See* CLARK, *supra* note 131, at 645; James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROB. 83, 114 (1985).

167. CLARK, *supra* note 131, at 645. In some instances the special litigation committee would recommend

served as the basis of the corporation's motion to dismiss the lawsuit.[168]

In *Zapata v. Maldonado*,[169] the Delaware Supreme Court approved of this process and announced a two-step analysis for considering a special litigation committee's motion to dismiss. First, the court was to consider the committee members' independence, good faith, and bases for their recommendation.[170] If satisfied as to these matters, the court could then engage in a second discretionary analysis and apply its own "independent business judgment" as to whether continuing the suit was in the corporation's interest.[171] Because the special litigation committee almost always recommended dismissal of the suit, and the courts typically deferred to the committee's recommendation,[172] this device has made it virtually impossible for plaintiffs, even those with valid claims, to survive this procedural mechanism. An exception to this deferential pattern came in *Lewis v. Fuqua*,[173] where the court of chancery denied a single-member special litigation committee's motion to dismiss due to extensive political and financial ties between the committee member and the corporation's CEO.[174]

4. Disney Litigation (Disney I)

The court of chancery decision in *In re the Walt Disney Co. Derivative Litigation (Disney I)*[175] demonstrates the power of these procedural mechanisms to frustrate plaintiffs' meritorious claims. Disney hired Michael Ovitz, a close friend of CEO Michael Eisner, as its president and chief operating officer. By all accounts, Ovitz's tenure at Disney was a spectacular failure. Within twelve months, Ovitz was seeking other employment. With Eisner's help, Ovitz negotiated a soft landing, departing Disney after fourteen months with a severance package worth $140 million. Disney shareholders brought a derivative action against Disney's directors and former directors. They alleged breaches of the fiduciary duties of care and loyalty both for initially approving Ovitz's employment contract and for subsequently approving Disney's non-fault termination of Ovitz, which entitled him to receive such exorbitant benefits.

The *Disney* defendants moved to dismiss the complaint for failure to make demand. Despite the extraordinary facts alleged in the case, the court displayed a skeptical attitude to the plaintiffs' case.[176] According to the court, the sheer dollar amount of the severance and the unusual circumstances under which it was granted did not mean that conventional

settlement of the lawsuit. COX & HAZEN, *supra* note 16, at 436.

168. CLARK, *supra* note 131, at 645.

169. 430 A.2d 779 (Del. 1981).

170. *Id.* at 788.

171. *Id*. at 789.

172. COX & HAZEN, *supra* note 131, at 436. *But see* Lewis v. Fuqua, 502 A.2d 962, 966-67 (Del. Ch. 1985).

173. 502 A.2d 962 (Del. 1985).

174. *Id.* A more typical decision deferring to the special litigation committee is *Kaplan v. Wyatt*, 484 A.2d 501 (Del. Ch. 1984).

175. 731 A.2d 342 (Del. Ch. 1998).

176. *See id.* at 350 (stating:

> Just as the 85,000 ton cruise ships *Disney Magic* and *Disney Wonder* are forced by science to obey the same laws of buoyancy as Disneyland's significantly smaller *Jungle Cruise* ships, so is a corporate board's extraordinary decision to award a $140 million severance package governed by the same corporate law principles as its everyday decision to authorize a loan).

corporate governance rules would not apply in evaluating the board's decision.[177] Instead, the court resolved to analyze the plaintiffs' claims "using the same tools it uses in any corporate law case, namely, the requirement of demand or its excusal, the *Aronson v. Lewis* test, the basic rules of disclosure and, most significantly, the business judgment rule."[178]

Central to the plaintiffs' claim of demand futility was that Eisner had an impermissible interest in Ovitz's employment contract, due to his close friendship with Ovitz. Eisner allegedly used his domination over the board to force them to approve Ovitz's ill-advised contract. The plaintiffs also argued that Eisner relied on his domination of the board to goad them to approve Ovitz's "non-fault termination" and the lucrative severance benefits granted thereunder.

The court gave little credence to these arguments.[179] Stating that "a board member is considered to be disinterested when he or she neither stands to benefit financially from nor suffer materially from the decision whether to pursue the claim sought in the derivative plaintiff's demand,"[180] the court limited its inquiry into Eisner's independence into any financial benefit to Eisner from the Ovitz agreement or the subsequent non-fault termination.[181] Finding that the plaintiffs had not credibly alleged such financial interest, the court held Eisner's independence beyond reproach.[182] In so holding, the court minimized the relevance of Eisner's relationship with Ovitz stating that "[d]emand is not excused . . . just because directors would have to sue 'their friends, family and business associates.'"[183]

The court also evaluated plaintiffs' claims that Eisner dominated the board of directors. Despite extensive personal and professional ties among Eisner and most of the other Disney directors, the court found that at least nine of the twelve board members were independent of Eisner. Not only did the court deem several Disney executives, former executives, and consultants independent of Eisner,[184] it also found independent individuals with more personal connections to Eisner. For example, Father Leo J. O'Donovan was president of Georgetown University, which Eisner's son had attended and to which Eisner personally had contributed more than $1 million.[185] Another director, Reveta Bowers, was the principal of the elementary school that Eisner's children once attended.[186] The court ruled that neither these personal connections to Eisner, nor

177. *Id*.

178. *Id*. at 350-51.

179. *Id*. at 355 (stating that "[t]he fact that Eisner has longstanding personal and business ties to Ovitz cannot overcome the presumption of independence that all directors, including Eisner, are afforded").

180. *Disney I*, 731 A.2d at 354.

181. *Id.* at 355-56.

182. *Id*. at 356 (declaring that "no reasonable doubt can exist as to Eisner's disinterest in the approval of the Employment Agreement, as a matter of law. Similarly Plaintiffs have not demonstrated a reasonable doubt that Eisner was disinterested in granting Ovitz a Non-Fault Termination . . . .").

183. *Id*. at 355 n.18 (quoting Abrams v. Koether, 766 F. Supp. 237, 256 (D.N.J. 1991) (applying Delaware law)).

184. *Id.* at 356-60 (deeming independent Roy Disney (a Disney executive), Cardon Walker (a former Disney executive, paid consultant, and investor in Disney films), Gary Wilson (retired executive whose wife was a paid Disney consultant), and former Senator George Mitchell (a paid consultant and attorney for Disney)).

185. *Disney I*, 731 A.2d at 359.

186. *Id.*

the relative significance of the directors' fees paid to these individuals created doubt as to their ability to act independently of Eisner.[187] Ultimately, the court concluded that because of plaintiffs' failure to demonstrate Eisner's interest in Ovitz's employment contract, and their failure to raise reasonable doubt of the independence of a majority of the directors, plaintiffs had failed to meet *Aronson*'s first prong for demand excusal.[188]

The plaintiffs fared no better under *Aronson*'s second prong, which required that the facts alleged raise a reasonable doubt that the "challenged transaction was the product of a valid exercise of business judgment."[189] The fact that directors had not calculated the total cost of the severance package was not fatal to the defendants' claim of business judgment rule protection. The court stated that "the board is not required to be informed of every fact, but rather is required to be reasonably informed."[190] Likewise, the court found plaintiffs' claims of waste deficient because "in the absence of fraud this court's deference to the directors' business judgment is particularly broad in matters of executive compensation."[191] The Disney directors' decision to grant Ovitz a non-fault termination, despite his non-performance and his own initiation of the termination of his employment, was also protected by the business judgment rule.[192]

On appeal, the Delaware Supreme Court upheld the dismissal of all of the plaintiffs' claims.[193] While displaying some concern about the Disney board's performance, the court reserved its contempt for the plaintiffs' pleading efforts. Calling the complaint a "pastiche of prolix invective,"[194] the supreme court agreed that plaintiffs had failed to satisfy the demand requirement.[195] In a partial reversal, however, the supreme court granted the plaintiffs' leave to amend their pleadings to satisfy the second prong of *Aronson* by alleging facts that created a reasonable doubt that the boards' decisions were entitled to business judgment rule protection.[196]

5. Question of Independence

The *Disney I* decision highlights the central role that independent directors play in providing a shield from liability for directors accused of a breach of duty. The standard for directorial independence is notoriously low.[197] Importantly, the Delaware courts rejected notions of structural bias that many argue significantly impact directors' decisions.[198] Under this rubric, even allegations of self-dealing that were not entitled to business judgment rule protection could be shielded from judicial scrutiny by relying on independent directors to reject demand or to dismiss derivative litigation through a

187. *Id.*
188. *Id*. at 363.
189. *Aronson*, 473 A.2d at 814.
190. *Disney I*, 731 A.2d at 362.
191. *Id*.
192. *Id*. at 364.
193. Brehm v. Eisner, 746 A.2d 244 (Del. 2000).
194. *Id.* at 249.
195. *Id.* at 248.
196. *Id*. at 267. The plaintiffs amended their complaint, and the amended complaint, considered post-Enron, received a different reception from the court of chancery. *See infra* text at notes 207-226.
197. Essentially plaintiffs had to show at the pleading stage, without the benefit of discovery, that a majority of directors would suffer financially unless they refused demand.
198. *See* Cox & Munsinger, *supra* note 166, at 85.

special litigation committee. These defenses presume the courts' acceptance of the defendants' claims that the directors charged with the relevant decision are "independent." Once courts display a willingness to question the defendants' claims of independent director decision-making, this protective veil falls away, and directors must defend their actions on the merits.

Similarly, business judgment rule protection depends on the court's acceptance of the notion that the board engaged in "informed, good-faith decision-making." If the courts question this presumption (even on occasion), the automatic protection of the business judgment rule becomes elusive. By denying defendants the benefit of the doubt, the courts can significantly alter the substantive law without altering judicial doctrine. Thus, the courts can execute the elegant maneuver of maintaining consistent legal standards while altering the stringency with which these standards are applied on a case-by-case basis.

D. Delaware Law: Post-Enron

Exposure of Enron's frauds triggered a national debate on the need for corporate reform. Even before Sarbanes-Oxley, Delaware jurists began to acknowledge the need for state-level reform to forestall federal action.[199] The Act's provisions merely sharpened the preemptive threat. Delaware's most recent corporate decisions depart dramatically from the tradition of management deference that preceded Enron.[200]

It is possible that Delaware would have proceeded on a path of reform absent the national debate that led to Sarbanes-Oxley. It is also possible that the recent jurisprudential shifts are simply a part of the natural norm evolution that characterizes the common law. Despite these possibilities, judicial comments expressing concern that Congress might displace Delaware's sovereignty provide a reason to explore other factors that might have contributed to this apparent shift.

In his *Business Lawyer* article, Vice-Chancellor Strine foreshadowed many of these judicially-led reforms. For example, Strine presaged reforms in standards for judging directorial independence, stating, "I believe that Enron will ignite a fiery debate centered upon the so-called 'independent director.'"[201] He predicted that plaintiffs will seek to "reverse existing presumptions, and ask our courts to presume, at the pleading stage, that directors who have questionable ties to management are not independent for purposes of dismissal motions."[202] He also predicted the tightening of procedural mechanisms for dismissing derivative litigation,[203] and the possibility of piercing the protective veil provided by exculpatory charter provisions.[204] On that score, Strine anticipated that "the court will be called on to conclude that a director who is conscious that he is not devoting

199. *See* Strine, *supra* note 117.

200. Some may counter that because the major scandals occurred at Enron, WorldCom, and Tyco, none of which were Delaware corporations, Delaware's legislature or judges should not bear any sense of responsibility for these scandals. Such analysis ignores the reality that all states have enacted enabling statutes that substantially mimic Delaware's legal rules, and that most other state courts look to Delaware for precedent on corporate law matters.

201. Strine, *supra* note 117, at 1373.

202. *Id.* at 1382.

203. *Id.* at 1383.

204. *Id.* at 1393.

sufficient attention to his duties is not acting in good faith, and is therefore not entitled to exculpation from damages liability."[205]

Delaware's recent decisions appear to draw on Strine's analysis. The courts have refused in preliminary motions to resolve directors' claims of independence in defendants' favor. Furthermore, the courts have denied defendants the protection of the business judgment rule in instances where it probably would have applied in the past.[206]

1. Duty of Care

In *In re Walt Disney Co. Derivative Litig.* (*Disney II*),[207] the court undermined the reliability of two stalwart defenses to due care claims: the business judgment rule and exculpation. In this decision, Chancellor Chandler, the author of *Disney I*, revisited the claims of plaintiffs who had objected to Michael Ovitz's generous severance package.[208] In the pre-Enron era, Chancellor Chandler had dismissed all of plaintiffs' claims.[209] In *Disney II*, he concluded that the boards' alleged conduct may have constituted such gross negligence as to violate Delaware's "good faith" requirements, thereby denying defendants exculpatory protections.

In *Disney II*, the plaintiffs' amended complaint alleged that Disney's directors failed to exercise any business judgment in approving Ovitz's employment agreement and his non-fault termination.[210] Some of the particularized facts in the amended complaint differed from the complaint presented in *Disney I*.[211] Viewed broadly, however, the amended complaint presented the same factual pattern shaped to comply with the limits of the supreme court's remand.[212]

The court evaluated plaintiffs' new allegations only under *Aronson*'s second prong: whether they alleged facts sufficient to raise a reasonable doubt that the challenged

205. It is interesting to note that the reasoning of the opinions in *Disney II, Telxon Corp. v. Meyerson*, 802 A.2d 257 (Del. 2002), *Krasner v. Moffett*, 826 A.2d 277 (Del. 2003), and *Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) rest largely on the arguments that Vice-Chancellor Strine articulated in his article.

206. Recent decisions have also applied stricter standards for evaluating board conduct in the takeover context. *See* MM Companies v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

207. 825 A.2d 275 (Del. Ch. 2003) [hereinafter *Disney II*].

208. *See supra* notes 182-199 and accompanying text.

209. The supreme court upheld the chancellor's ruling, but reversed the "with prejudice" aspect of the dismissal of plaintiffs' claims that the boards' processes were not entitled to business judgment rule protection. *Brehm*, 746 A.2d at 248.

210. *Disney II*, 825 A.2d at 277-78.

211. The plaintiffs had obtained access to corporate books and records (including board minutes and corporate correspondence) allowing them to provide better factual support for their allegations. Perhaps the most legally significant difference between the old and new complaints was the plaintiffs' allegation in *Disney II* that compensation expert Graef Crystal had not advised the board on Ovitz's agreement. This new allegation eliminated the directors' potential section 141(e) defense of reliance on experts. The new complaint also alleged that Disney's board never formally approved Ovitz's non-fault termination and the consequential severance payments, weakening the directors' claims of business judgment rule protection.

212. Both complaints tell the same basic story: Disney's board capitulated to Eisner in hiring his close friend Ovitz, providing a generous compensation package and severance terms that created perverse incentives by guaranteeing payment for failure. The board compounded its error by permitting Ovitz's non-fault termination which locked in benefits to which Ovitz (based on his performance as president) was not entitled.

transactions were entitled to business judgment rule protection.[213] This time Chancellor Chandler concluded that allegations did create such doubt.[214] Remarkably, he rejected the defendants' exculpation defense, ruling that the facts alleged created a reasonable doubt as to whether the directors acted "honestly and in good faith."[215] Because section 102(b)(7) forbids exculpation for "acts or omission not in good faith," this ruling offered plaintiffs a path around the exculpatory provision's formidable protective barrier. Reminiscent of the widely-disparaged *Van Gorkom*[216] decision, the court lambasted the board's decision-making process, scrutinizing the amount of time it spent considering Ovitz's agreement (ten minutes), the page length of the board minutes (one and one-half pages) and the information made available to the board at the time of such approval.[217]

In *Disney I*, Chancellor Chandler adopted a deferential approach to evaluating board conduct. He dismissed as insignificant the board's alleged failure to quantify the value of Ovitz's termination payout, stating that "[a] board is not required to be informed of every fact, but rather is required to be reasonably informed."[218] In a remarkable reversal, in *Disney II*, Chancellor Chandler found the plaintiffs' allegations quite troubling:

> These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a "we don't care about the risks" attitude concerning a material corporate decision.[219]

Such harsh scrutiny of board conduct departs sharply from the attitude exhibited in *Disney I*, which opens with irreverent metaphors to cruise ships and theme park rides.[220]

213. Aronson v. Lewis, 473 A.2d 805 (Del. 1984). This treatment was consistent with the supreme court's order in *Brehm*, 746 A.2d at 262.

214. *Disney II*, 825 A.2d at 288-89.

215. *Id*. at 286.

216. 488 A.2d 858 (Del. 1985).

217. *Disney II*, 825 A.2d at 287-88.

218. *Disney I*, 731 A.2d at 362.

219. *Disney II*, 825 A.2d at 289. Chancellor Chandler attributed the different outcome on the two different allegations in the new complaint. *Id.* at 279 & n.5. Although this is a plausible explanation of the different outcomes on the motions to dismiss, it fails to fully account for the differences in tone, language, and legal conclusions between the two court of chancery opinions. More seems to be going on than the simple application of consistent legal standards to the facts presented to the court. It seems likely that an altered legal and political environment contributed to Chancellor Chandler's shift in approach. In *Brehm*, Chief Justice Veasey described the facts in *Disney I* as "troubling." *Brehm*, 746 A.2d at 249. Concurring, Justice Hartnett viewed the allegations sufficient to survive dismissal. *Id*. at 268 (Hartnett, J. concurring). In addition, Chief Justice Veasey put the public spotlight on *Brehm* (and implicitly, the court of chancery's prospective ruling in *Disney II*) as an example of how the Delaware courts were willing to scrutinize directors' executive pay decisions. *See Roundtable, supra* note 2, at 76. Thus, the partial reversal in *Brehm*, Chief Justice Veasey's widely-disseminated comments, and intervening supreme court decisions such as *Telxon* (discussed *infra* Section VI.D.2), represent significant additional factors that may have pushed the court toward the legal conclusions reached in *Disney II*.

220. *Disney I*, 731 A.2d at 350:

> Just as the 85,000 ton cruise ships *Disney Magic* and *Disney Wonder* are forced by science to obey the same laws of buoyancy as Disneyland's significantly smaller *Jungle Cruise* ships, so is a corporate board's extraordinary decision to award a $140 million severance package governed by the same corporate law principles as its everyday decision to authorize a loan. . . . Nature does

Chancellor Chandler also seems to revise his approach to the significance of Eisner's friendship with Ovitz. Despite ruling in *Disney I* that the relationship had no bearing on Eisner's or the board's independence,[221] he refers directly to Eisner's and Ovitz's friendship at least fifteen times in the course of his opinion.[222]

In addition to refusing to dismiss claims against Disney's directors, the court let stand claims against Ovitz for breach of fiduciary duty, finding "the facts alleged, if true, would support an inference that Ovitz may have breached his fiduciary duties . . . by negotiating his employment agreement directly with his personal friend Eisner."[223] With respect to Ovitz's negotiation of a non-fault termination with Eisner the court concluded that the facts alleged "would suggest a faithless fiduciary who obtained extraordinary personal financial benefits at the expense of the constituency for whom he was obliged to act honestly and in good faith."[224] The court held that because the terms of Ovitz's employment and termination involved directorial self-compensation, such decisions lay outside the business judgment rule's presumptive protection, and was subject to a showing that the compensation was fair.[225] In *Disney I*, the court had summarily rejected this same argument, without acknowledging that the fairness test would apply to evaluate the loyalty claim.[226]

2. Duty of Loyalty

Delaware's recent jurisprudence also makes it more difficult for defendants to dispose of duty of loyalty claims. In particular, the courts have undercut the protective value of independent committee approval for conflict of interest transactions. The strict fairness test that applied to cash-out mergers, has been applied more broadly to a range of contexts including recapitalizations, corporate opportunity, and conflicts caused by interlocking directorates.

a. Telxon Corp. v. Meyerson

In *Telxon Corp v. Meyerson*,[227] the court adopted a more stringent test for director independence. It also ruled that the question of director independence was not appropriate for determination on a summary judgment motion due to the factual nature of the inquiry. The *Telxon* court considered allegations that directors had breached their duty of loyalty

> not sink a ship merely because of its size, and neither do courts overrule a board's decision to approve and later honor a severance package, merely because of *its* size.

221. *Id.* at 355. The supreme court upheld this aspect of the court's ruling. *Brehm*, 746 A.2d at 258. Therefore, the independence issue was not before the court on remand.

222. Chancellor Chandler addresses this apparent incongruity in his opinion:

> The allegation that Eisner and Ovitz had been close friends for over twenty-five years is not mentioned to show self-interest or domination. Instead, the allegation is mentioned because it casts doubt on the good faith and judgment behind the Old and New Boards' decisions to allow two close personal friends to control the payment of shareholders' money to Ovitz.

Disney II, 825 A.2d at 287 n.30.

223. *Id*. at 290.

224. *Id*. at 291.

225. *Id*. (citing *Telxon*, 802 A.2d at 265).

226. *Disney I*, 731 A.2d at 380.

227. 802 A.2d. 257 (Del. 2002).

by permitting the board chairman to usurp a corporate opportunity.[228] The central figure in the case was Robert Meyerson, chairman of the board and a paid consultant to the company. The plaintiff alleged that Meyerson had breached his duty of loyalty by personally developing a product within the company's line of business, and selling the technology back to Telxon for $17.3 million.[229] The plaintiff also alleged that the other directors breached their duties by approving or acquiescing in these transactions.[230] The court of chancery granted the defendants' motion for summary judgment on the duty of loyalty claims.[231]

The Delaware Supreme Court reversed.[232] The supreme court agreed with the plaintiff that a material dispute existed as to the directors' independence, creating questions as to whether such directors could make an independent decision not to pursue the business opportunity in question.[233] The court rejected defendants' arguments that independent directors had approved all of the challenged transactions entitling them to business judgment rule protection stating that "[d]irectors must not merely be independent, but must act independently."[234]

The plaintiff sought to rebut the business judgment rule's presumptions by alleging that Meyerson dominated the board. The plaintiff cited Meyerson's influence on the directors' compensation, his important position in the company, and the fact that the directors "respected his business acumen and often relied on his counsel" to support its allegations.[235] The court of chancery had dismissed these arguments, correctly observing that "Delaware courts have consistently rejected assertions that a personal friendship without more, establishes a lack of independence."[236]

In contrast, the supreme court opined "we cannot say whether or not the other Directors acted independently or were beholden to Meyerson such that they deferred to his will . . . ."[237] The court therefore reversed, stating that, "[o]nly after a full picture of Meyerson's relationship with the other Directors is developed can their independence be ascertained."[238] Thus, despite many successful preliminary motions granted on the basis of directors' assertions of facial independence,[239] the court in *Telxon* held that a fuller factual record was necessary to make such a determination.[240]

228. *Id.* at 259-62.
229. *Id*. at 261.
230. *Id.* at 266. The plaintiffs also alleged that the directors had breached their duties by awarding themselves excessive compensation. *Id.*
231. *Telxon*, 802 A.2d at 262.
232. *Id.* at 266.
233. *Id.* at 264-65.
234. *Id*. at 264 (citing Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997)).
235. *Id*. at 265.
236. Merchants' Nat'l Props., Inc. v. Meyerson, 2000 WL 1041229, at *5 (Del. Ch. July 24, 2000).
237. *Telxon*, 802 A.2d at 265.
238. *Id*.
239. *See, e.g.*, *Brehm*, 746 A.2d at 264; Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991); Kahn v. Roberts, 1995 WL 745056, at *5 (Del. Ch. 1995).
240. *Telxon*, 802 A.2d at 264-65.

b. Krasner v. Moffett

Krasner v. Moffett[241] reiterated *Telxon*'s holding. In *Krasner*, the supreme court again rejected a defense premised on the ability of a committee of independent directors to cleanse a conflict of interest transaction. In *Krasner*, two related corporations, Freeport McMoRan Sulphur, Inc. (FSC) and McMoRan Oil and Gas Co. (MOXY), entered into merger negotiations.[242] Because the two corporations had a number of common board members, each formed a special committee of independent directors to negotiate the merger.[243] Under the terms of the resulting merger agreement, MOXY shareholders received a greater percentage interest in the merged entity than the FSC shareholders.[244] FSC shareholders challenged the merger claiming that its directors had violated their fiduciary duties by approving a transaction that was unfair to FSC.[245] The court of chancery granted defendants' motion to dismiss based on the special committee's role in negotiating the transaction and recommending it to the full FSC board.[246] The court reasoned that because none of the plaintiffs' allegations impugned the integrity of the special committee, the FSC board's decision would be evaluated under the business judgment standard of review.[247]

The Delaware Supreme Court reversed,[248] rejecting the defendants' arguments that the special committee process cleansed the conflicts of interests.[249] It ruled that the directors had the burden of proving that the committee was independent and had real bargaining power, a burden they could not satisfy at the motion to dismiss stage.[250] As in *Telxon*, the supreme court stated that "independence of the special committee involves a fact-intensive inquiry that varies from case to case. Thus, we cannot assume at the pleading stage that the defendants will carry the burden of establishing independence."[251]

Two new rules seem to have emerged from *Telxon* and *Krasner*. First, approval by facially independent directors no longer suffices to shield conflict of interest transactions from judicial scrutiny.[252] Actual independence measured in deeds, rather than financial interest, appears to be the new standard.[253] Second, the question of independence seems to have shifted from primarily a legal issue to be resolved by a judge on a preliminary motion, to a question of fact entitling the plaintiff to discovery and a trial on the merits.[254] This approach would seem to repudiate the standards established in *Aronson*, which facilitated dismissal at the pleading stage based on the strong presumptions of directorial independence.

241. 826 A.2d. at 277.
242. *Id.* at 279-80.
243. *Id.* at 280.
244. *Id.*
245. *Id*. at 281.
246. *Krasner*, 826 A.2d at 281-82.
247. *Id*.
248. *Id*. at 289.
249. *Id*. at 284.
250. *Id*. at 284-85.
251. *Krasner*, 826 A.2d at 286; *see also Telxon*, 802 A.2d at 265.
252. *See Krasner*, 826 A.2d at 284-87; *Telxon*, 802 A.2d at 264-65.
253. *Telxon*, 802 A.2d at 264 ("Directors must not only be independent but must act independently.").
254. *Krasner*, 826 A.2d at 284-85.

3. Procedural Protections

The Delaware courts have also made it more difficult for defendants to prevail using the standard procedural maneuvers that frequently ensured early dismissal of derivative litigation. In addition to the more stringent test for defeating a claim of demand futility on display in *Disney II*, *In re Oracle Corp. Derivative Litig.*[255] dealt a blow to the previously reliable special litigation committee device. In *Oracle*, the court rejected a shareholder litigation committee's claims of independence, finding the relationships among the members of the special committee and the defendants were fraught with conflicts.[256] The court reached this conclusion despite the absence of the sort of financial dependence that *Disney I* and *Aronson* held as essential to finding a lack of independence.

In *Oracle*, the plaintiffs sued four Oracle directors (including CEO Larry Ellison) for breaching their duty of loyalty by engaging in insider trading.[257] Oracle formed a special litigation committee ("SLC"), comprised of two Stanford University professors recruited for the committee by two of the defendants.[258] The SLC engaged in a lengthy investigation of the plaintiffs' claims and produced a 1,100-page report that concluded that continuing the litigation was not in the corporation's interests.[259] The SLC then moved to terminate the derivative action.[260] Applying *Zapata*, Vice Chancellor Strine concluded that the SLC had failed to persuade him that it was sufficiently independent to evaluate the merits of the litigation objectively.[261] He uncharacteristically dissected the SLC members' ties to the defendants which centered around their connections to Stanford University. Both SLC members, Joseph Grundfest and Hector Molina-Garcia, were Stanford professors and alumni.[262] The defendants included Michael Boskin, a Stanford economics professor,[263] and William Lucas, a Stanford alumnus who had contributed almost $16 million to Stanford.[264] In addition, defendant CEO, Larry Ellison, had contributed more than $10 million to Stanford, and had negotiated with the school about a potential $170 million contribution to establish an "Ellison Scholars" program at Stanford.[265]

Vice Chancellor Strine ruled that such extensive social and professional connections precluded any presumption that the SLC would evaluate the plaintiffs' claims solely on their merits, untainted by collegial sympathy or institutional loyalty.[266] He therefore concluded "this was a social atmosphere painted in too much vivid Stanford Cardinal red

255. 824 A.2d 917 (Del. Ch. 2003).
256. *Id*. at 920, 942.
257. *Id.* at 920.
258. *Id.* at 923-25.
259. *Id*. at 925.
260. *Oracle*, 824 A.2d at 928.
261. *Id.* at 942.
262. *Id*. at 923-24.
263. *Id*. at 930-31. Boskin taught Grundfest when Grundfest was a Ph.D. candidate at Stanford and also served alongside Grundfest as a senior fellow and steering committee member of a prestigious Stanford research institute. *Id*.
264. *Oracle*, 824 A.2d at 931-32.
265. *Id*. at 932-34. Ellison had also publicly stated his intention to bequeath his $100 million Silicon Valley estate to Stanford. *Id*. at 935.
266. *Id.* at 942.

for the SLC members to have reasonably ignored it. Summarized fairly, two Stanford professors were recruited to the Oracle board . . . and soon asked to investigate a fellow professor and two benefactors of the University."[267]

While acknowledging that "there is admittedly case law that gives little weight to ties of friendship in the independence inquiry,"[268] Strine rejected a formalistic approach to questions of independence asserting that, "Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus*. We may be thankful that an array of other motivations exist that influence human behavior . . . ."[269]

4. Question of Independence

A common thread weaves through Delaware's recent opinions. The courts express a new reluctance to credit defendants' arguments which are premised on the assertion that the directors charged with making the challenged decision were independent. In *Telxon* and *Krasner*, the court undermined the cleansing power of independent committee approval of conflict transactions by weakening the independence presumption, at least for purposes of preliminary motions.[270]

In *Oracle*, the court flatly rejected the directors' assertions of independence that might have been accepted in earlier times. Vice Chancellor Strine squarely acknowledged that his ruling departed from precedent stating:

> I readily concede that the result I reach is in tension with the specific outcome of certain other decisions. But I do not believe that the result I reach applies a new definition of independence; rather, it recognizes the importance (i.e., the materiality) of other bias creating factors other than fear that acting a certain way will invite economic retribution by the interested directors.[271]

In *Disney II*, a case in which the courts had finally adjudicated the question of the directors' independence in the defendants' favor, Chancellor Chandler nonetheless based much of his ruling on an underlying presumption that (a) Eisner had an interest in Ovitz's employment arrangements and (b) Eisner dominated the board of directors.[272] Absent Eisner's domination and control, why would the board, as alleged by the plaintiffs, abdicate all responsibility for monitoring and approving Ovitz's employment and termination arrangements? Furthermore, in finding that Ovitz may have breached his duty of loyalty by negotiating directly with Eisner, rather than the independent compensation committee, the Chancellor again impugned Eisner's independence.[273]

267. *Id.* at 947. Vice Chancellor Strine also stated: "In my view an emphasis on [']domination and control['] would serve only to fetishize much-parroted language, at the cost of denuding the independence inquiry of its intellectual integrity." *Oracle*, 824 A.2d at 935.

268. *Id.* at 939.

269. *Id.* at 938.

270. Telxon Corp. v. Meyerson, 802 A.2d 259, 264-65 (Del. 2002); Krasner v. Moffett, 826 A.2d 277, 286 (Del. 2003).

271. *Oracle*, 824 A.2d at 939 n.55.

272. *Disney II*, 825 A.2d at 287-90.

273. *Id.* at 290-91.

5. Summary

Admittedly, the small number of cases discussed above forms a small sample for making ultimate conclusions about the proper role of federal and state governments in shaping corporate law rules. Nonetheless, a fundamental shift in Delaware corporate jurisprudence does seem to have occurred. Two Delaware judges (including the chief justice) have publicly stated their belief in the necessity of legal reforms in light of the scandals and the federal preemptive threat.[274] In addition, corporate practitioners have taken notice of the courts' trend toward higher scrutiny of board decision-making.[275] These lawyers' advice to their clients in light of these decisions further supports the inference that a shift in jurisprudence has occurred.[276] As Professor Rock has argued "[i]n a world of vaguely defined norms and rapidly evolving transactional forms what the business lawyer tells the client . . . is the law."[277]

E. Looking Forward

The foregoing analysis demonstrates the evolution of a trend toward stricter judicial decision-making in Delaware. The emergence of this trend correlates in time with significant corporate reforms at the federal level. In addition, public statements from influential Delaware judges support the argument that these recent developments form part of an effort to forestall further preemption. Other observers have reached similar conclusions on the likely explanation for the perceived shift in jurisprudence.[278] Despite the strong circumstantial evidence presented here, it is impossible to definitively establish the precise reasons for this widely-perceived shift. In fact, at least one Delaware judge rejects the proposition that the factors identified in this Article actually influence judges in their decision-making.[279] Having laid out the case that the preemptive threat plays a

274. *See* Roundtable, *supra* note 2; Strine, *supra* note 117.

275. *See* J. Travis Laster & Michael K. Reilly, *A Warning Shot for Directors? Delaware Supreme Court Reverses Four Court of Chancery Decisions*, INSIGHTS, Feb. 2003, at 2 (stating that "the issuance of four decisions adverse to directors within a short time period is noteworthy").

276. *See, e.g.*, Memorandum from Weil, Gotshal & Manges, to "Our Clients and Friends" on Director Liability Warnings from Delaware (Jan. 10, 2003) (on file with author); Memorandum from Meredith M. Brown & William D. Regner, Debevoise & Plimpton, to "Our Clients and Friends," on What's Happening to the Business Judgment Rule? (June 19, 2003) (on file with author) (discussing *Disney II*, *Oracle* and *In re* Abbott Laboratories, 325 F.2d 796 (7th Cir. 2002), and concluding, "in our view, recent Delaware cases indicate an increased risk of director liability"); Memorandum from Martin K. Lipton & Paul K. Rowe, Wachtell, Lipton, Rosen & Katz, The Business Judgment Rule is Alive and Well (June 18, 2003) (on file with author) (discussing *Disney* and *Abbott Laboratories* and observing that "these two decisions are examples of the heightened scrutiny that all board conduct is subjec to in the post-Enron climate").

277. Rock, *supra* note 74, at 1096.

278. *See, e.g.*, Marc Gunther, *Boards Beware*, FORTUNE, Nov. 10, 2003 ("It would not be unreasonable to assume that the Delaware courts are responding to the Enron and WorldCom headlines and the intrusion, so to speak, of the federal government into the internal governance of corporations." (quoting former Delaware Chancellor William T. Allen)); *Triumph of the Pygmy State*, ECONOMIST, Oct. 25, 2003 at 55, 56. ("Reacting to the latest anti-business sentiment in Washington, D.C., Delaware's judges appear ready to adopt a more hawkish line on the duty of directors to represent shareholders' interests.").

279. In comments to the author, Chancellor Chandler states:

> Judges (whether or not you believe this) decide cases based on the particularized facts before them, not on whether it will affect the competitive position of the state via other competitors for corporate

significant role in Delaware's current jurisprudence, I must leave it to readers to accept or reject this argument. For those who are receptive to the analysis set forth here, a few prescriptive observations are in order.

There is reason to suspect that if the federal threat recedes, Delaware will revert to its more lax jurisprudence.[280] The history of Delaware law is replete with examples of the imposition of strict judicial standards, followed by prolonged periods of deference. The same indeterminacy that permits judges to impose more restrictive standards of director conduct can be used to relax such standards when the political climate changes.[281] Though perhaps inescapable, this possibility only bolsters arguments for sustained federal engagement in corporate governance issues to prevent such retrenchment. Congress must continue to monitor corporate conduct, remaining apprised of developments in state corporate codes and jurisprudence. In addition, Congress must be willing to preempt objectionable state law rules.

Congress can maintain a credible preemptive threat by demonstrating a sustained interest in corporate governance issues. The SEC, through its enforcement and rule-making functions, should remain at the forefront of this vigilance. Congress can demonstrate its continued engagement by holding hearings on governance issues, investigating corporate misconduct, and actively overseeing the SEC's enforcement of federal securities laws, including the Sarbanes-Oxley Act.

VII. CONCLUSION

The response in Congress and in Delaware to the recent corporate scandals demonstrates that the model of vertical regulatory competition framed in the Federalist Papers endures. This political dynamic also reveals flaws in modern federalist arguments denouncing national-level regulation. Unreflective allegiance to the internal affairs doctrine and the economic theories invoked in its defense should no longer serve to dissuade Congress from preempting objectionable provisions of state corporate law. Instead, the threat of federal preemption remains a necessary predicate to the ability of the national citizenry to pressure the state of Delaware to shape its corporate law to reflect national rather than parochial interests.

> charters . . . And in a larger sense, I also think academics sometimes miss the point that judges are not legislators, and they are not given a commission to change the laws based on the headlines of the day.

E-mail from William B. Chandler III, Chancellor, Delaware Court of Chancery, to author (Nov. 6, 2003)(on file with author).

280. *Van Gorkom*, 488 A.2d at 858, and *Singer v. Magnavox Co*., 380 A.2d 969 (Del. 1977), are examples of Delaware decisions that imposed strict standards of liability that were later reversed or disregarded by courts.

281. *Rock*, supra note 74, at 1105.